Send to
S. Hilton
("Type 3")
2 sets of
F/S
- Am GAAP
- CAN GAAP

Sandy -
collect 96, 97
first - then
98 will
be easy.
for

Realizing the Vision:

CN

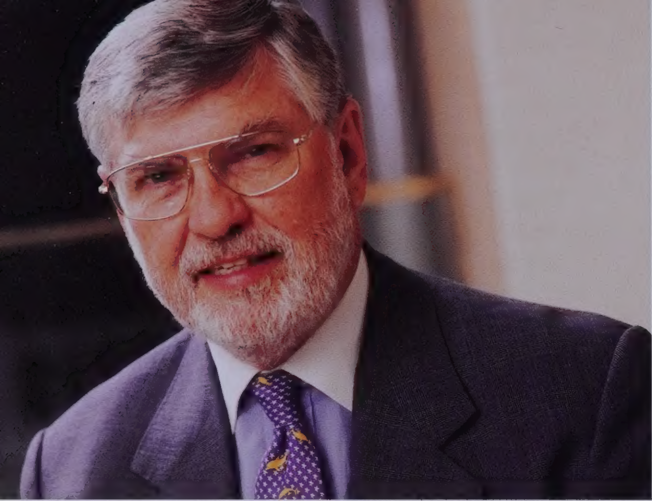
The New

CN

A North American Railroad

Contents

Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars and determined on the basis of United States generally accepted accounting principles (U.S. GAAP).



David McLean

Nineteen ninety-eight was a landmark year for Canadian National. Our company continued to meet challenge with bold action, announcing in February the planned merger with Illinois Central Corporation (IC). This joining of two great railroads will create a new carrier on the North American landscape, giving shippers more options in the increasingly competitive transborder economy.

The CN-IC merger agreement is not the sole accomplishment of note for the year. CN performed well in 1998, despite the impact of economic difficulties in Asia, posting significant progress in focusing on its customers and finding more efficient ways to run the railroad. On behalf of the Board of Directors, I commend CN management's strength and vision in tackling the challenges we faced during the year. The Board is very proud of CN's thousands of employees whose commitment and hard work contributed equally to our success.

I'd also like to congratulate Paul Tellier on his selection as Canada's Outstanding CEO of the Year in 1998 by a board of Canadian business leaders. This is more than a testament to Mr. Tellier's leadership and vision – it's an honor for the entire company.

CN's Board took on an added North American dimension in 1998 when Gilbert H. Lamphere and Alexander P. Lynch became directors. Mr. Lamphere is the former chairman of the board of Illinois Central Corporation. Mr. Lynch, a former director of IC, is a general partner of The Beacon Group, a private investment and financial advisory firm in New York City. Both bring valuable perspective to the Board with their considerable U.S. rail expertise.

On behalf of the Board of Directors, I wish to convey thanks to our shareholders for their continued support. We are more confident than ever in our ability to deliver long-term shareholder value, whatever challenges the future brings. Indeed, we are well on our way to building a railroad that will excel in the new century.

Sincerely,

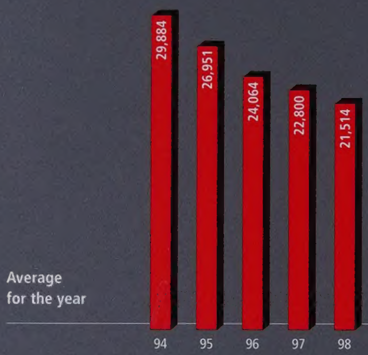
David McLean

David McLean
Chairman of the Board

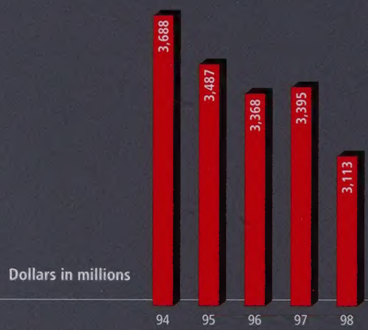
The New CN

There's a new CN emerging. After the profound promise and change of privatization more than three years ago, our company is entering the next exciting phase. Through our proposed merger with Illinois Central and other initiatives, we are realizing our vision of a new CN – a truly North American railroad, delivering customer access to markets across the continent with unprecedented reach, focus and performance.

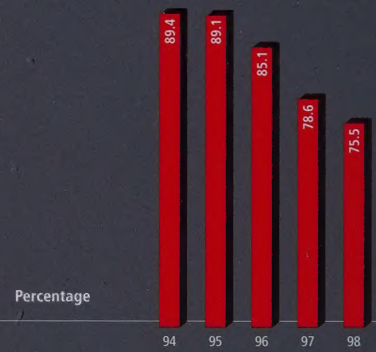
EMPLOYEES



OPERATING EXPENSES
(Excluding special charges)



OPERATING RATIO
(Excluding special charges)



$ in millions, except per share data, or unless otherwise indicated	1998	1997	1996	1995	1994
Financial results					
Revenues	**$ 4,121**	$ 4,322	$ 3,956	$ 3,912	$ 4,126
Operating expenses excluding special charges	**3,113**	3,395	3,368	3,487	3,688
Special charges	**590**	–	365	1,415	–
Operating income (loss)	**418**	927	223	(990)	438
Operating income excluding special charges	**1,008**	927	588	425	438
Interest expense	**242**	117	113	194	192
Equity in earnings of Illinois Central Corporation	**105**	–	–	–	–
Other income	**43**	62	41	119	64
Foreign exchange (loss) gain	**(26)**	(38)	3	29	(47)
Income (loss) from continuing operations	**224**	469	848	(1,017)	235
Income from continuing operations excluding special charges	**569**	469	1,055	398	235
Capital expenditures	**744**	609	291	324	508
Diluted earnings (loss) per share from continuing operations	**2.42**	5.44	9.88	(12.64)	2.94
Diluted earnings per share from continuing operations excluding special charges	**6.16**	5.44	12.28	4.95	2.94
Rail operating ratio excluding special charges *(%)*	**75.5**	78.6	85.1	89.1	89.4
Statistical highlights					
Route miles *(includes Canada and the U.S.)*	**13,741**	15,292	17,124	17,918	18,414
Carloads *(thousands)*	**2,456**	2,547	2,315	2,295	2,354
Gross ton miles *(millions)*	**216,501**	228,353	208,328	204,143	211,805
Revenue ton miles *(millions)*	**112,929**	119,534	107,470	105,487	109,004
Rail employees *(average for the year)*	**21,514**	22,800	24,064	26,951	29,884
Diesel fuel consumed *(Canadian gallons in millions)*	**234**	272	259	256	266
Average price per Canadian gallon *(dollars)*	**$ 1.08**	$ 1.23	$ 1.22	$ 1.08	$ 1.03

When I began as President and Chief Executive Officer of this company in 1992, we started on the road to becoming the best railroad in North America. At the time, it seemed a distant and lofty goal. While I am always careful to remind everyone that we are still a work in progress, six years later that goal has never seemed more within our reach. Today we are the most improved railroad on the continent, as well as one of the safest. And pending U.S. Surface Transportation Board (STB) approval of our proposed merger with Illinois Central, we are poised to become the first truly North American railroad, connecting three coasts with a single rail network.

Despite a set of very challenging circumstances, I am pleased with CN's 1998 financial performance. Net income in 1998, excluding non-recurring items, was $569 million compared to $457 million in 1997, excluding non-recurring items and discontinued operations, an increase of 25 per cent. Related diluted earnings per share were $6.16 compared to $5.31, an increase of 16 per cent year-over-year. Operating income for 1998, excluding a special charge, increased to $1,008 million versus $927 million in 1997.

With 1998 Canadian grain shipments significantly down, and automobile revenues affected by a labor dispute at one of our large customers, CN's revenues for 1998 were $4,121 million, a five per cent decrease from last year's $4,322 million.

We were able to offset the decline in overall revenues through effectively managing our 1998 operating expenses of $3,113 million, excluding a special charge, an improvement of eight per cent compared to a year ago. CN achieved excellent results in its continuing drive to reduce its operating ratio in 1998. At year-end, it stood at 75.5 per cent, 3.1 points better than at year-end 1997 and 2.2 points better than our goal for 1998.

CN's redesigned service plan, with its focus on delivering predictable, reliable service, means we require fewer assets and fewer employees to run our railroad. With labor productivity still well behind that of our competitors in the United States and revenues down from the previous year, we made the difficult decision to decrease CN's workforce by 3,000 in the second half of 1998 and full-year 1999. We took a pre-tax special charge of $590 million in third-quarter 1998 to pay for severance and other payments to affected employees.

For CN to continue to be successful in the long term, we have had to make gains in our productivity. This has meant many changes in the company, in the way we do business, and a total focus on meeting our customer commitments with the most efficient service offering possible. These changes have meant we conduct our business with fewer people and fewer assets than ever before. The decisions we take to

"The key to growth for CN lies in the north-south trade corridor, where traffic is increasing annually at a significant rate."

reduce our workforce are never easy, but I am committed to treat fairly any employees affected by these changes.

We have often said that the key to growth for CN lies in the north-south trade corridor, where transborder traffic continues to expand. This year we made several strategic moves to extend our customers' reach in North America, led by our proposed merger with Illinois Central.

Illinois Central represents a perfect fit for CN. IC's 3,450 miles of track meet CN's network at Chicago with no overlap. The IC network stretches due south from Chicago to the Gulf of Mexico, and west from Chicago to the U.S. agricultural heartland. The merger will match strength to strength – the most improved railroad with the most efficient – and join two similar cultures that have a proven record of working together.

As President and Chief Executive Officer, my challenge is to combine the strengths of both companies to create a railroad with a passion for service, while preserving the proud traditions of each. If the transaction is approved by the STB as anticipated, we are prepared to move quickly to bring the benefits of the merger to the marketplace.

In another strategic initiative which did not require regulatory approval, we entered into a marketing alliance with IC and Kansas City Southern Railway (KCSR). This agreement, for an initial 15-year term, creates a unique network linking Canada, the U.S. Midwest and South and, through KCSR affiliates, the third NAFTA country, Mexico.

Once the merger is approved, we will implement a third strategic initiative: a separate access agreement between CN and KCSR that will include certain haulage rights in the southern United States and joint investment in facilities at key points on our networks.

Even with our merger, we will be dwarfed by the large U.S. railroads, which have spent the last several years pursuing and implementing mergers of their own. Combined CN-IC revenues for 1998 are U.S.$3,508 million – the smallest of the big four is Norfolk Southern, with U.S.$4,221 million in revenues. It is no secret that the pace of consolidation among large carriers has caused problems in the past for shippers. The new CN is committed to being more customer focused and more nimble than our larger competitors. We will strive to set a new standard for service while providing a viable alternative network for shippers.

In 1998, CN maintained and improved its standing as one of the safest Class 1 railroads. There were no fatalities at CN during the year. But we can never be satisfied. We will always work to improve our safety performance. Our goal: to have every employee return home safely – every day.

To this end, we implemented the Responsible Care® initiative across CN's various operating districts. In 1997, CN

Paul M. Tellier

became the first Canadian transportation company to join Responsible Care®, a performance improvement initiative established by the Canadian Chemical Producers' Association and the Chemical Manufacturers Association to enhance employee health and safety, protect the environment and reduce the risk to the public inherent in the transportation of dangerous goods. As a partner in Responsible Care®, CN has made an enormous, long-term commitment to its community, employees, customers and shareholders. Everyone will know that they can expect the highest standards of safety and ethical conduct from CN – and that's good for business.

This year we signed three-year agreements with all our Canadian unions, completing negotiations without any work disruptions. Going forward, this willingness to work together will help CN compete in the challenging and constantly changing North American business environment.

Heartfelt thanks are due to our employees. CN underwent a great deal of change in 1998, and I know that change involves challenging adjustments. This is why I am more grateful than ever for their dedication to helping us meet our goals.

I would like to welcome E. Hunter Harrison, former President and CEO of Illinois Central Corporation, who joined CN as Executive Vice-President and Chief Operating Officer in March 1998. With Hunter aboard, CN now has a remarkable management team in place – the strongest in our history.

I appreciate the support our shareholders have given us this year. Justifying that support remains a top priority. As I look around me at CN – at our many talented people, at our plans and the progress we're making – I know we are on the right track. Moving ahead to face the challenges of 1999 and beyond, I have a strong sense that we are doing the right things to reach our goal of becoming the best railroad on the continent.

Yours sincerely,

Tellier

Paul M. Tellier

President and Chief Executive Officer

Extending our

customers' reach

CN took several major steps to enhance customer access to North American markets in 1998. Our proposed merger with IC; the strategic marketing alliance among CN, Illinois Central and Kansas City Southern Railway; and a pending access agreement with KCSR all support our vision of creating an efficient transportation network that enables trade and contributes to customer competitiveness.

CN-IC: Building a railroad for the 21st century

Our proposed merger with Illinois Central is the perfect fit at the perfect time. The merger will create North America's first three-coast railroad, offering customers single-line service from the Atlantic to the Pacific to the Gulf of Mexico. It's a perfect fit because the two networks do not overlap, joining end-to-end at Chicago. And it's the perfect time because north-south transborder rail traffic has been growing at double-digit rates.

IC was the most efficient railroad in North America in 1998 with a 64.9 per cent operating ratio, excluding special charges. IC's success in the past resulted from initiatives that reduced locomotive and crew costs, increased yard and line capacity and improved asset utilization. Successful integration of IC and CN will accelerate the pace of operating improvements and dramatically enhance the quality of our service.

The CN-IC merger combines two railroads with similar cultures: both share an intense focus on customer service, efficiency and safety. The two railroads have demonstrated compatibility through the joint development of the Gateway Intermodal Terminal in Chicago. The CN-IC transaction delivers clear benefits to shippers – no anticompetitive effects, no abandonment of redundant lines, no service reductions and no adverse labor, safety or environmental effects.

As the first truly North American railroad, CN will deliver many advantages to shippers, including new destinations and origins, more competition for their business, reduced transit times, better fleet utilization and increased backhaul opportunities. Moreover, CN will provide longer hauls to offer a more viable alternative to trucks. In short, the new CN will deliver seamless, competitive access to an entire continent.

Creating a NAFTA network

In April 1998, CN, IC and KCSR announced a 15-year strategic marketing alliance that offers shippers extended reach through a network linking points in Canada, the Midwest and southern U.S. markets. Through KCSR affiliates, the alliance also provides shippers access to Mexico's largest rail system, Transportación Ferroviaria Mexicana (TFM).

CN, IC and KCSR coordinate sales and marketing, operations, fleet management and information systems. The alliance gives customers enhanced transportation options and improved access to markets in the key north-south transborder and other significant U.S. corridors with just one call. This means more efficient service through Chicago, North America's rail hub, resulting in significantly better transit times. As a pro-competitive marketing agreement, this initiative applies to all traffic movements except where any two of the alliance partners provide the only direct rail service.

Also in 1998, CN and KCSR signed a separate access agreement, contingent upon STB approval of the CN-IC merger, that would give shippers new competitive options in Alabama, Mississippi and Louisiana. Under the agreement, CN and KCSR will jointly invest in key automotive, intermodal and transload facilities, with joint use for 25 years regardless of any change in corporate control.


2521
2521
CNRU
291595
1994

A conversation with Paul M. Tellier

CN President and Chief Executive Officer

What do you mean by "a North American railroad?"

Simply put, I mean truly North American in terms of reach, strategic orientation and culture. This is important because, more and more, the arena where our customers do business is the North American arena. Soon, north-south traffic will account for more than half of CN's business.

Every strategy we have pursued since I assumed leadership of this company has supported our goal to be a truly North American railroad. Every improvement we have made in our business has been designed to make us more competitive with railroads south of the border and to enhance our ability to support cross-border trade.

The proposed merger between CN and IC; the strategic marketing alliance among CN, IC and KCSR; and the proposed access agreement between CN and KCSR represent huge strides toward achieving our goal.

What will this mean to customers?

It will mean enhanced and expanded access to North American markets. And it will mean more rapid improvements to the quality of service CN provides customers.

Fostering a passion for service among our people is a major focus at CN. This is why I recently presented a ten-point "Customer Bill of Rights," outlining what shippers have the right to expect from us:

1. **Customer focus.** A focus on customers that guides all our actions.
2. **Quality service.** Quality based upon a clear, mutual understanding of what's expected.
3. **Performance standards.** Clearly measurable performance in terms we both agree upon.
4. **Consistent delivery.** Goods consistently delivered within agreed-upon time frames.

5. **Accountability.** Taking full responsibility for service commitments.
6. **Transparency.** If we miss on a commitment, telling shippers why and, more importantly, how we'll correct it.
7. **Competitive pricing.** Pricing that will help keep shippers competitive.
8. **Quality equipment.** Modern, well-maintained equipment that safely meets customer needs.
9. **Resourcefulness.** More than responding to shippers' transportation needs – providing innovative approaches to helping them access more markets.
10. **Partnership.** Service based on true partnership – where our interests are their interests.

The Customer Bill of Rights represents a set of standards that we always strive for. We are not there yet, but we are making progress.

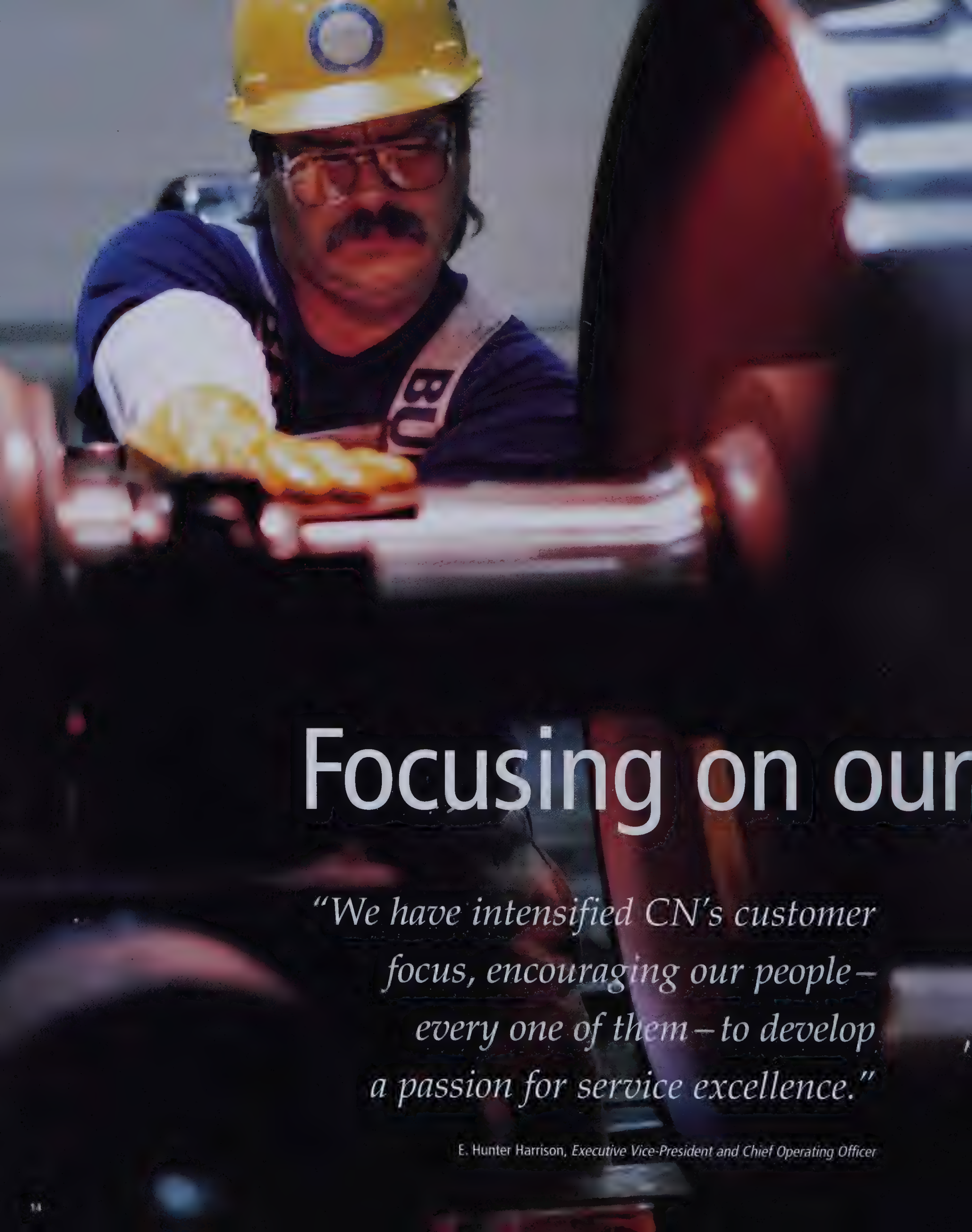
What will Michael Sabia's and Hunter Harrison's roles be in the new CN?

Well, first of all, Michael and I have worked very closely together since we began the turnaround six years ago. He wears two hats – he's the Chief Financial Officer, but he's also a top strategist. I brought Michael Sabia in as a strategic thinker. He has been, and will continue to be, one of the key forces behind CN's accomplishments.

Hunter Harrison is a very strong railroader, one of the best in North America. It is no coincidence that IC had the lowest operating ratio in the industry. He's already had a tremendous impact on our performance – his leadership will take us to the next level of service excellence and efficiency.

"With approval of the CN-IC merger, we will be the only transcontinental railroad with single-line access to three coasts – Pacific, Atlantic and Gulf of Mexico."

Paul M. Tellier, *President and Chief Executive Officer*



Focusing on our

"We have intensified CN's customer focus, encouraging our people – every one of them – to develop a passion for service excellence."

E. Hunter Harrison, *Executive Vice-President and Chief Operating Officer*

customers' success

At CN, 1998 was a year of intensified focus on customer service. We adopted changes in operating procedures, radical even for a company that has undergone a total transformation since 1992.

A new attitude

The new CN uses the word "passion" to describe a new level of commitment – a passion for customer service, a passion for reliability, a passion for the most efficient use of our assets. CN's new attitude is driven by the knowledge that the already competitive shipping environment is only going to become more intense; the economic challenges ahead will increase, not abate. So we know that ongoing improvement is not an option, it's an imperative. That's why we spent the year looking at every aspect of how we do business. The result: the CN service plan.

The CN service plan

Beginning in third-quarter 1998, CN introduced the next phase in the evolution of its service plan. The objective is to deliver on customer commitments with marked improvements in the reliability of our service – while increasing efficiency and reducing operating costs. This plan fundamentally changes how CN runs its trains, manages its yards and communicates with its customers.

We know we must have top-quality delivery on trip plan commitments. Under the service plan, we redesigned our normal operations to run regularly scheduled trains that leave at predetermined times, which results in more reliable car supply, switching and documentation. Customers know when shipments will leave and when they will arrive within the hour, dramatically enhancing their ability to plan. Trains are spaced evenly, like a conveyor belt, which greatly enhances efficiency of yard operations. There are now multiple outlets between yards to help preserve smooth traffic flow.

To meet changing customer requirements, the service plan provides the necessary flexibility, when a given train is full, to add cars or run extra trains as needed. To optimize trainloads without compromising customer service quality, CN now is managing the system as a network, looking for opportunities to combine shipments from different business groups, such as intermodal/automotive and merchandise. These general purpose trains handle unit traffic that can move in regular freight service, allowing us to fill idle capacity.

The plan also makes significant changes to the way CN manages cars, decreasing the number of times a car is handled, thereby reducing costs and improving overall transit times. Car handling in yards has been reduced to no more than two classifications per car. More balanced traffic flow has enabled us to look at the tightest connections possible at our yards. When the plan is fully implemented, dwell time will be reduced from an average of 36 hours to 18. Cars no longer wait in yards, in most cases connecting directly from the transfer assignment to the destination train. We are further reducing yard congestion throughout the network by systematically eliminating hold and stored cars.

For carload traffic, CN is now quoting transit times, door-to-door rather than yard-to-yard, at a new level of precision – in hours, rather than days. And CN can provide customers the railroad's on-time delivery performance record for a given customer and route.

The sum total of the changes brought about by the service plan enables CN to deliver a superior product to customers – better communication, better transit times and, most importantly, reliable, predictable service.






DWC 605270



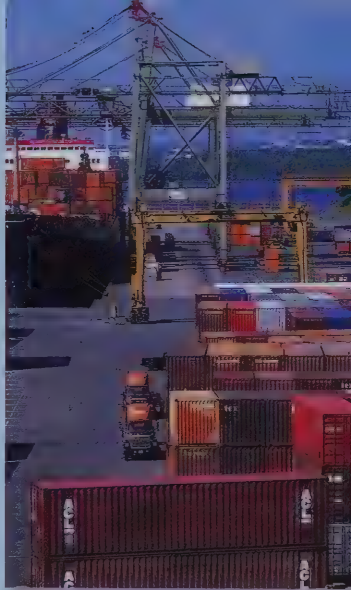




MAERSK
MAERSK

A conversation with E. Hunter Harrison

CN Executive Vice-President and Chief Operating Officer



What do you see as your mission in your new role at CN?

I started out with two short-term objectives. The first was to refine CN's scheduled service offering. We made excellent progress on that front in 1998. The second was to develop a sound operating and marketing plan that builds on the collective strength of two superb rail systems, CN and IC. This is now complete. Once the STB approves our merger application, we will have a well thought-out plan that allows us to move quickly and safely to put in place our new single-line service network.

What I'm trying to do now is lead an evolution to the next step, which is to foster a stronger commitment, *a passion*, for customer service. We are talking about a company-wide shift in attitude – where every single person in this organization is focused on the customer and committed as never before to operating the railroad to a new level of precision.

We have developed a service plan after evaluating everything we do and, in many cases, we've made major changes. Under the plan, trains have precise timetables and run on schedule. These schedules are stated in hours, rather than days, and we consistently achieve them. We closely monitor performance and share the results with our customers. At the same time, we do not promise either our customers or our colleagues that which we cannot deliver.

What is the most important aspect of what you're trying to bring about?

We want people to realize that this is not a project with a set time frame. It's a complete change in the way we want everyone in the organization to look at things. The philosophy driving our plan emphasizes improvement as an ongoing, never-ending process. We expect to improve our ability to deliver precise, consistent service month after month, year after year.

How is the service plan different from the initiatives that were well under way at CN before you came on board?

Remember, CN is the most improved railroad in North America, so change is already part of its culture. What we're doing here is accelerating the pace of change, and making it more profound.

For example, we've changed our approach to the businesses – merchandise, bulk, intermodal and automotive. Before, because each group developed its own product – designed it, produced it, took it to market – there were missed opportunities. Now we're operating as a network – gaining leverage in sharing assets, capacity and, sometimes, train service – coordinating shipping between groups without negatively impacting the service offering.

Overall, we're making changes in operations to deliver a better product. Our plan for running the railroad emphasizes train schedules that make more sense for our system, an intensified focus on asset utilization and, above all, providing customers with consistent, reliable service.

Is it possible to improve service in an aggressive cost containment environment?

I have always been a believer that there's a compatibility between good service and lower cost. If you're going to provide precision to the customer, then you have to apply the same kind of precision to your assets in terms of cars and locomotives. When you increase scheduling precision with a more coordinated, network approach, a natural result is increased asset utilization which allows us to dramatically reduce locomotive and car fleets. At the same time, we're providing an even higher level of service. Believe me, we will have lower cost and better service.












Emphasizing perfor

The new CN has intensified its drive for excellence at every level of the company: increasing our reach to enhance customer competitiveness and their ability to access new markets; fundamentally changing our operating approach to bring unprecedented service reliability and productivity; and setting a new industry standard for safety.

Dramatic productivity gains

A key outcome of the service plan is greatly improved asset utilization. The results have been as startling as they have been immediate. Better planning has resulted in the effective elimination, through a combination of disposition, lease-out and storage, of more than 500 locomotives in 1998, leaving CN with a more modern, fuel-efficient fleet. Up to 200 of these locomotives were placed in storage, capable of being brought back on line within 72 hours if needed. In addition, reduced yard dwell time and increased car velocity resulting from the plan have enabled us to effectively cut the CN-controlled car fleet by more than 10,000 cars, or approximately 15 per cent of the fleet, in 1998.

The cost savings resulting from these fleet reductions are significant. With fewer locomotives, CN requires less fuel, less material and fewer people to run and maintain the fleet. More efficient use of existing locomotives, combined with those in storage, has reduced the need to order new ones. CN has delayed orders for 40 new locomotives that were due for delivery in 1999, resulting in significant savings in capital expenditures. Plus, costs related to leasing power to meet surges in demand are eliminated.

More efficient yards mean more balanced workload and better use of labor. Better trip planning has significantly reduced deadheading of train crews – wherever possible, crews are now switched at the midway point of two passing trains, returning each crew to its respective point of origin. Intermediate terminals ideally result in a crew working four hours out and four hours back, rather than working eight hours out and deadheading eight hours back. These improvements in productivity benefit CN employees as well, providing an enhanced quality of life, with more time at home with their families and a more predictable work schedule.

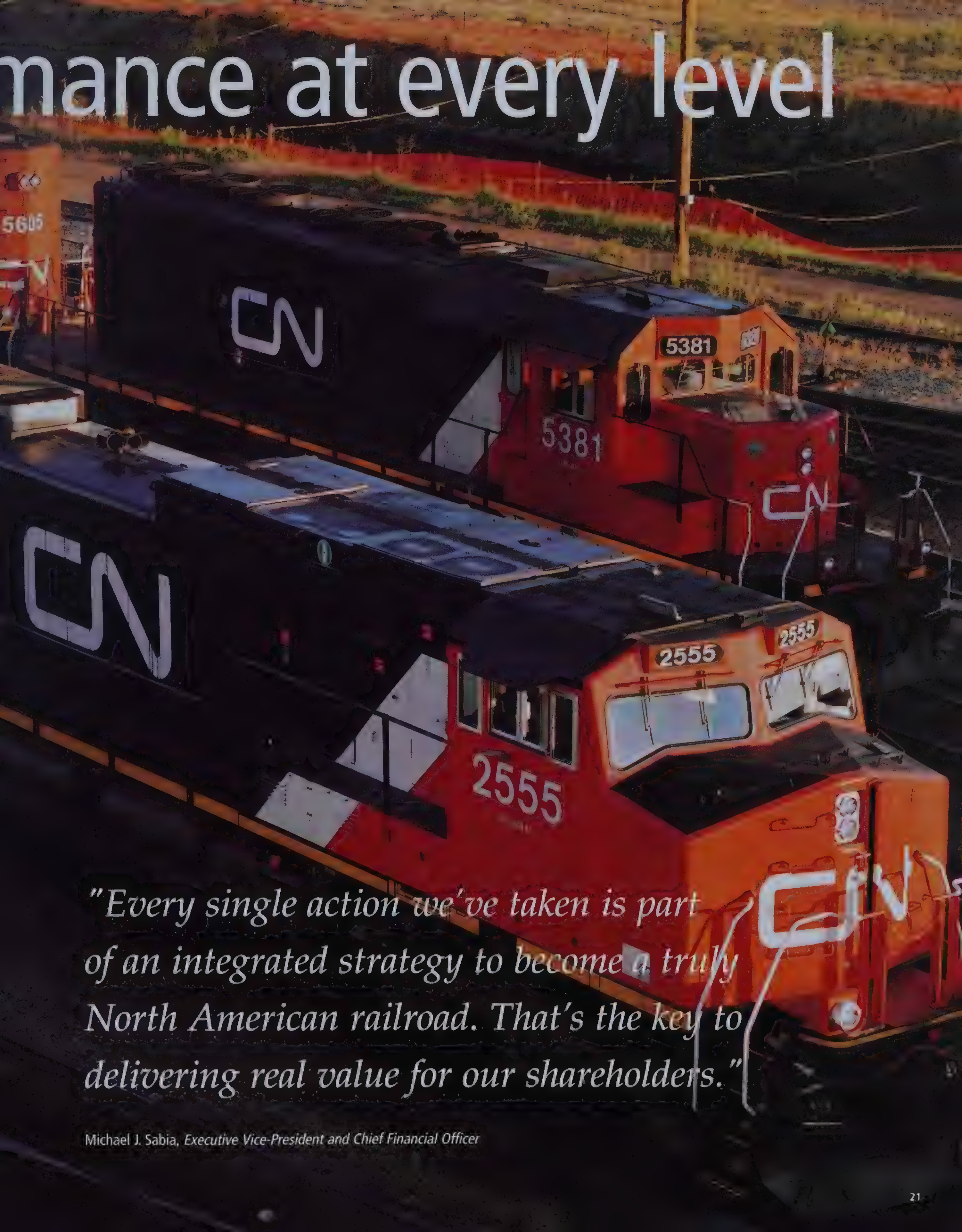
Ongoing improvements in network efficiency

CN's network rationalization program – the sale to short lines or abandonment of track – is continuing to transform the company into a more efficient long-haul railroad. Since its beginning in 1992, the program has benefited CN, local customers and communities, as well as independent short-line operators. In 1998, CN discontinued or sold to short-line railroads approximately 1,500 miles of track, bringing to approximately 8,000 miles the total amount of secondary track eliminated from our network since 1992.

A continued commitment to safety performance

Over the past several years, CN has intensified efforts to improve safety and adopted programs aimed at changing employees' attitude and behavior. These efforts bore fruit by the end of 1997, when CN achieved its goal of becoming the safest Class 1 railroad with only a 2.2 train accidents per million train miles ratio on a U.S. Federal Railroad Administration (FRA) reporting basis. In 1998 we further improved our record 1997 performance with a 1.4 FRA accident rate, unprecedented in the rail industry. But we remain focused on improvement – even one accident is one too many.

In everything we do, we are pushing CN performance to become more than a North American railroad – we are striving to become the best railroad in North America.



mance at every level

"Every single action we've taken is part of an integrated strategy to become a truly North American railroad. That's the key to delivering real value for our shareholders."

Michael J. Sabia, *Executive Vice-President and Chief Financial Officer*


2441
2441
5755

How does the merger relate to CN's overall strategy?

Our strategy since the beginning has been to develop the platform for becoming a genuinely North American company. Doing that required radical change in the cost structure of the business. This was accomplished in the period before and immediately after CN was privatized.

We are now seeing a second round of dramatic change. Our proposed merger with IC gives us the opportunity to penetrate the U.S. market more deeply, to harness trade flows as a source of traffic and to grow revenues over the medium term. To do this successfully, we have had to sharpen our focus on customers. Equally important, we're striving to get the maximum out of our assets, using them so intensely that we can reduce the number of locomotives and railcars, and significantly improve cash flow – all the while making sure that our efforts translate to real value for our shareholders.

This is important: every aspect of being North American is connected, part of a single, integrated strategy. Really intensive asset utilization will drive more reliable service. The customer side and financial side reinforce each other. Better service and more predictability can be achieved with fewer locomotives and railcars. Being North American requires more than a few isolated changes in how we operate – it's a pervasive commitment to change throughout the organization.

What does the North American strategy mean to shareholders?

It's the way CN is steadily increasing profitability, strengthening cash flow and improving return on investment. From a shareholder standpoint, that's what we're in business to do.

For instance, there's been a revolution at CN in terms of free cash flow performance. It's been dramatic. We went from negative free cash flow of $118 million in 1995 to positive free cash flow of $228 million in 1998.

A conversation

with

Michael J. Sabia

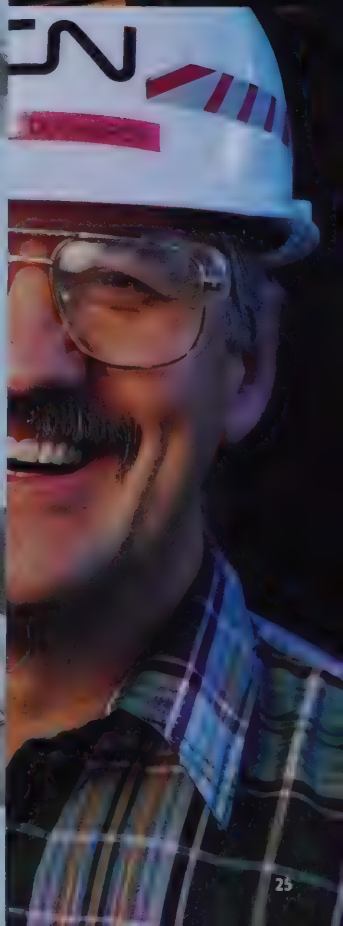
CN Executive

Vice-President

and

Chief Financial

Officer



To accomplish this, we started to run our business against free cash flow targets. This drives us to look for every single opportunity to generate value out of our assets, such as the arrangements we have with telecommunications companies for fiber optic installations along our rights-of-way. When you have a right-of-way that goes from one end of the country to the other, it's a valuable asset. But that's just one example. Generally speaking, the notion of focusing on cash flow is an important ingredient in running our business in a more disciplined way.

What pleases you most about CN's performance in 1998?

I am most proud of the fact that we have vastly improved the financial durability of the company – in other words, CN's capacity to generate quality, predictable earnings despite the inevitable ups and downs we encounter. Before the turnaround, we did not know how to adjust quickly to changing events. So, early on we set a goal to make CN a more durable company.

When I look at what we have accomplished in 1998, faced with a set of circumstances very few were predicting – problems in Asia, the stock markets, lower growth, depressed commodity prices and labor disputes – I'm pleased. While clearly we haven't been able to deliver the kind of revenue performance we would have been able to generate in the absence of these events, we have met the challenge of enhancing our durability. We've been successful at finding opportunities to manage costs in such a way that, within reason, protects earnings. In 1998, we built a company that's much less susceptible to big swings in the business cycle than in the past. That's gratifying, but neither Paul, Hunter nor I are satisfied. There's a lot left to do in every area of our business. CN is still a work in progress.


5661
5661

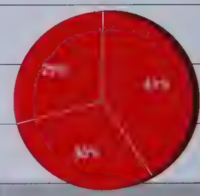
Canadian National Railway Company *operates a network of approximately 13,750 route miles of track in Canada and the United States, generating revenues from the movement of a diversified and balanced portfolio of industrial products; forest products; grain and grain products; coal, sulfur, and fertilizers; intermodal; and automotive.*

In 1998, CN had an average of approximately 21,500 employees serving customers across North America.

At the end of 1998, CN operated approximately 1,400 locomotives and a railcar fleet of approximately 64,000. The precision scheduling of trains through CN's service plan has allowed the company to significantly reduce the assets needed to provide top quality service to its customers. Compared to 1997, CN effectively removed from

REVENUE – TRAFFIC MIX

Per cent

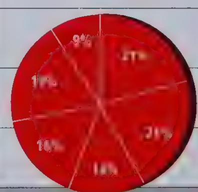


41% U.S. domestic and transborder
30% Overseas
29% Canadian domestic

CN at a glance: today..

FREIGHT REVENUES

1998 percentage data



21% Industrial products
21% Forest products
14% Grain and grain products
16% Coal, sulfur, and fertilizers
19% Intermodal
9% Automotive

We manage our six business units in three business groups based on the type of service our customers require and the assets needed to provide that service: merchandise (single car), bulk (unit train), and intermodal/automotive (just-in-time). For customers in each of our businesses, our proposed merger will mean significant new options to reach more markets and a predictable, reliable service offering to help them to be competitive.

The extended reach of the new CN system will increase gateway choices and enable our customers' goods to flow over a more efficient route. The new CN will also contribute to our customers' success through unified marketing strategies, single-source pricing and integrated information systems.

Greater movement efficiencies will mean enhanced equipment availability and better car cycle times for customer-owned fleets. Computerized shipment management over our expanded network will provide accurate and more timely deliveries, supporting customer inventory and fleet management. With access to the entire system, customer service will be enhanced by a single contact point, resulting in more rapid response for service requirements and problem resolution.

The new CN will combine two of North America's safest railroads to provide direct service linking major resource and producing regions to strengthen our customers' position with their domestic and overseas competitors.

MERCHANDISE GROUP

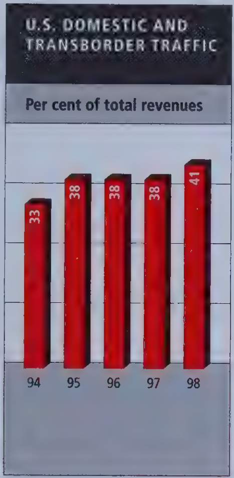
Industrial products

This business includes a wide range of commodities such as chemicals and plastics, petroleum and gas products, metals and construction materials. The new CN will connect chemical and petroleum producers in eastern and western Canada with producers in the Gulf Coast region.

Forest products

CN's forest products business consists of lumber, panels, fibers and paper. Forest product traffic originates in regions of extensive lumber reserves and moves either via CN's main corridor from western Canada to Chicago, or from northeastern Canada to midwestern and eastern interchange points with other U.S. railroads. The new CN will directly link three of the four great lumber producing regions in North America – western Canada, eastern Canada and the southern United States.

service more than 500 locomotives and more than 10,000 railcars, with significant reductions in operating and maintenance costs.



The new CN *that will result from the merger with Illinois Central will be the only transcontinental railroad in North America and also the only railroad to serve all three coasts on the continent. Through a marketing alliance with the Illinois Central and the Kansas City Southern Railway, CN customers can effectively reach all three NAFTA nations.*

The new CN will be well positioned to compete against other rail carriers and trucks for growing north-south transborder traffic, while delivering distinct advantages to U.S. and Canadian shippers. With lean, flexible operations, extended transcontinental reach, and a passion for service, the new CN is North America's railroad.

and tomorrow

BULK GROUP

Grain and grain products

CN's grain and grain products business consists primarily of wheat, barley and canola. Much of this traffic moves from western Canada to terminals at Vancouver and Prince Rupert on the west coast, and to Thunder Bay on Lake Superior for export. Our new franchise will have a substantial position in the U.S. corn and soybean producing regions, and the new CN will be able to offer customers access to three coasts to export their products to the world.

Coal, sulfur, and fertilizers

The majority of traffic in this business unit originates in western Canada and is exported to the United States or overseas from ports in British Columbia. Canadian sulfur, potash and phosphate rock are exported for the production of fertilizers. The new CN will offer customers an extensive fan network into the United States, allowing them to access more markets and gateways.

INTERMODAL/AUTOMOTIVE GROUP

Intermodal

CN serves both domestic and overseas customers with its just-in-time intermodal service. CN is the only transcontinental railroad in North America serving ports on the Atlantic and Pacific coasts, with doublestack service to Chicago. The new CN will add the Gulf Coast and offer customers new competitive options to reach Kansas City and Dallas. The integrated intermodal service will offer a timely, reliable and competitive option to shippers currently relying on trucks.

Automotive

CN is a leading carrier of automotive products originating in southwestern Ontario and Michigan, a region that accounts for some 40 per cent of all vehicles produced in Canada and the United States. CN transports finished vehicles and parts within Canada and the United States, and in both directions across the border. CN also serves customers importing vehicles to North America through Vancouver and Halifax. The new CN will give vehicle and parts shippers access to new rail routings that connect destinations in Canada, the U.S. and Mexico.

1998 DATA

Freight revenues	(In millions)
Industrial products	$874
Forest products	851
Grain and grain products	554
Coal, sulfur, and fertilizers	644
Intermodal	762
Automotive	385

Revenue ton miles	(In millions)
Industrial products	23,095
Forest products	22,977
Grain and grain products	18,937
Coal, sulfur, and fertilizers	25,830
Intermodal	19,913
Automotive	2,177

Freight revenue per revenue ton mile	(In cents)
Industrial products	3.78
Forest products	3.70
Grain and grain products	2.93
Coal, sulfur, and fertilizers	2.49
Intermodal	3.83
Automotive	17.68

"I established this program to reward and recognize employees who make outstanding contributions to Canadian National. It's important to recognize employees who demonstrate new ways of serving our customers and who take up the challenge of change."
–Paul M. Tellier

Category 1: New business opportunities

Mike Corr, Terry Doherty, Carole Johannesson, Victor Santiago and Ken Wallin

Marketing identified a significant rail business opportunity in petroleum coke. Working with government, short lines, terminal operators and truckers, the CN/Sumitomo team was able to put together a five-year total logistics package that will generate in excess of $40 million.

Category 2: Safety

Rick Dare, Bob Lower, Bob Phillip, Gerry Rauch, Gord Smith and Scott Stevens

The team developed a new approach which addresses personal injuries, and asset and process losses at the Symington Heavy Repair Center. This strategy serves to focus attention on changing the safety culture and is meant to be an ongoing process whereby all employees can voice concerns at any time as well as recommend solutions. All indicators show that the process is extremely effective.

Category 3: Exceptional service

Bill Mann

Over a period of three years, Bill worked with the Customer Service Log – a process designed to identify recurring internal problems and store information regarding customer exceptions. This process takes complaints and turns them into opportunities.

Category 4: Operational breakthrough

Saleem Amleh, Brent Anderson, Darcy Bain, Cole Burbridge, John Caissie, Brent Champion-Taylor, Al Dickinson, Jerry Dunford, Garnet Dunn, Dave Ellis, Steve Gajerski, Wayne Genik, André Haaksma, Mark Horobec, Mariana Kelemen, Beverly Knudtson, Emma Korucuoglu, Rhonda Leavey, Chris Macht, Mario Moretto, Brad Norrad, Pearl Pinga, Len Podgurny, Emilio Prato, Jim Schultz, Mike Tamilia, René Thellend and Christian Viens

This team simplified and accelerated transborder shipping through the elimination of all paperwork and the adoption of electronic processing and customs clearance. It introduced pre-processing and reduced waiting time at the border.

Category 5: People management

Dwight Tays

Dwight was extremely resourceful and tactful in the task of consolidating the Gordon, Taschereau and MacMillan diesel shops into the MacMillan Yard Locomotive Reliability Center. He has created a strong management team and instituted regularly scheduled meetings that have been highly effective in making the LRC a smooth-running operation.

Category 6: Cost effectiveness

William Blevins, Carole Bluteau, Bill Collier, Alan Crossley, Johanne Dandurand, Bob Dunn, Peter Ford, Hugh McBride, Lucie Richard and Tom Wheatley

The team has managed to reduce CN's annual fuel expenses by over $10 million. They provided a strategic solution that will ensure long-term sustainable cost reductions and negotiating leverage for the company. This initiative demonstrated the value of establishing a highly effective cross-functional team in order to achieve CN's goals.

Category 7: Quality improvement

Ricardo Alejandre, Dave Craig, Emanuel Galea, Don Gallant, Manjit Gill, Brian Mollan, Pierre Rovtar, Larry Schamber and Dave Wilson

The team identified many opportunities for improvement through process analysis and the setting and meeting of targets on a day-to-day basis. They were instrumental in increasing undercutter productivity, while at the same time reducing delays in customer traffic.

Category 8: Environmental impact

Yves Goulet

Yves has brought together an environment committee which meets monthly to discuss and resolve issues. On an ongoing basis, he personally undertakes inspections of the facilities to ensure that the environmental protection measures have been instituted.

Contents

Canadian National Railway Company

1998 overview – Solid results despite a challenging environment*

Performance for 1998 was characterized by revenue shortfalls from reduced grain volumes and labor disruptions affecting key customers. This lower-than-expected revenue performance was offset by the implementation of successful cost management initiatives combined with the introduction of a comprehensive service plan. As a result, CN was able to achieve the following:

- **Operating ratio betterment of 3.1 points to 75.5% on the strength of an 8% improvement in operating expenses;**
- **First year ever with operating income above $1 billion, a 9% increase over 1997;**
- **25% year-over-year increase in net income to $569 million;**
- **16% improvement in diluted earnings per share over 1997 to $6.16;**
- **36% reduction in accident rate over 1997;**
- **19% reduction in injury frequency rate over 1997;**
- **On-time performance of 89% and 84% for intermodal/automotive and merchandise trains, respectively; and**
- **Customer satisfaction index up 10 points to 77%.**

**Excludes cumulative effect of change in accounting policy, 1998 special charge, and 1997 gain on sale of interest in joint venture and discontinued operations.*

Year ended December 31,	**1998**	1997	1996
Rail operations			
Freight revenues *($ millions)*	**4,070**	4,255	3,886
Gross ton miles *(billions)*	**216.5**	228.4	208.3
Revenue ton miles (RTM) *(millions)*	**112,929**	119,534	107,470
Route miles *(includes Canada and the U.S.)*	**13,741**	15,292	17,124
Operating expenses excluding special charges per RTM *(cents)*	**2.76**	2.84	3.13
Freight revenue per RTM *(cents)*	**3.60**	3.56	3.62
Carloads *(thousands)*	**2,456**	2,547	2,315
Freight revenue per carload *($)*	**1,657**	1,671	1,679
Diesel fuel consumed *(Canadian gallons in millions)*	**234**	272	259
Average fuel price *($/Canadian gallon)*	**1.08**	1.23	1.22
Revenue ton miles per Canadian gallon of fuel consumed	**483**	439	415
Locomotive bad order ratio *(%)*	**8.0**	10.1	11.2
Freight car bad order ratio *(%)*	**3.4**	3.7	4.0
Productivity			
Operating ratio excluding special charges *(%)*	**75.5**	78.6	85.1
Freight revenue per route mile *($ thousands)*	**296**	278	227
Revenue ton miles per route mile *(thousands)*	**8,218**	7,817	6,276
Freight revenue per average number of employees *($ thousands)*	**189**	187	161
Revenue ton miles per average number of employees *(thousands)*	**5,249**	5,243	4,466
Employees			
Number at end of year	**19,198**	21,081	21,589
Average number during year	**21,514**	22,800	24,064
Labor and fringe benefits per RTM *(cents)*	**1.14**	1.11	1.31
Injury frequency rate per 200,000 person hours	**1.3**	1.6	2.1
Accident rate per million train miles	**1.4**	2.2	3.0
Financial			
Debt to total capitalization ratio *(% at end of year)*	**45.0**	29.4	33.0
Return on assets *(% at end of year)***	**5.9**	6.7	5.3

**Excludes Illinois Central Corporation.*

***Income from continuing operations before cumulative effect of change in accounting policy, adjusted to exclude special charges.*

Certain of the 1997 and 1996 comparative figures have been reclassified in order to be consistent with 1998 presentation.

- **CN-IC merger**
In early 1998, CN and Illinois Central Corporation (IC) entered into a merger agreement whereby the Company went on to acquire all of the common stock of IC for a combination of cash and CN shares valued at approximately U.S.$2.4 billion. The IC shares purchased by CN were placed in a voting trust pending approval of the Company's control application by the U.S. Surface Transportation Board (STB). The STB approval, while expected verbally in March 1999 and in written form in May 1999, cannot be assumed.

Combining CN and IC will create a stronger railroad to serve both carload and fast-growing intermodal markets. CN-IC is a perfect fit for customers. This shipper-driven transaction links the Atlantic, Pacific and Gulf of Mexico coasts to create the only truly North American railroad. It offers customers single-line access to major markets and six key ports in North America. Customers will benefit from new competitive options, improved service reliability, safer transportation, shorter transit times, better fleet utilization and car availability, enabling customers to reduce their overall logistics costs. CN and IC also plan new rail services to become more efficient within the Chicago area.

The CN-IC merger will generate the following:

Revenue synergies: The transaction will create revenue growth opportunities by extending length of haul and interchanging traffic with other railroads at more favorable gateways other than Chicago, as well as capturing traffic currently interchanged to other carriers. By developing efficient reload centers for large volume commodities, markets not accessible at either end of the combined CN-IC network will be within reach, opening new market opportunities in several business units.

Cost synergies: The combination is also expected to enhance CN's ability to reduce unit costs as it extends single-line hauls from both eastern and western Canada into and from the U.S. market, further improving equipment cycle times and availability. Further cost savings will also result from corporate overhead reduction as well as consolidation of yard and maintenance shops.

Operating efficiencies: The merger is an end-to-end combination that will improve operating efficiencies, particularly in the area of asset utilization, without reliance on significant headcount reductions or network rationalization;

- **15-year marketing alliance formed among CN, IC and KCSR**
This marketing alliance offers shippers pro-competitive connections to rail routes for their products and the ability to access more markets through a coordinated rail service. The alliance links points in Canada with the major U.S. Midwest markets of Detroit, Chicago, Kansas City and St. Louis, along with the key southern markets of Memphis, Dallas and Houston. In addition, this alliance gives shippers access to Mexico through Kansas City Southern Railway (KCSR) affiliates. The companies coordinate sales and marketing, operations, fleets and information systems, but not for traffic movements where any two of them provide the only direct rail service. CN-IC-KCSR expect the marketing alliance to generate revenue and earnings growth and position them as the pre-eminent north-south rail carriers in the NAFTA corridor, where north-south transborder rail traffic has been growing annually at double-digit rates;

- **Service plan**
Our goal is to provide safe, reliable, predictable service. Since implementation, we have seen significant improvements in asset utilization and operating efficiency with longer trains, less horsepower per trailing ton, reduced train starts and expense reductions in labor, material and fuel.

Currently, the focus is on trip plan compliance. Although only select flows are presently measured, eventually all traffic will be measured. We want to run our trains to an optimum schedule, with only minimal variance to the day-to-day plan. We are developing a product catalog that lists virtually every CN origin-destination combination. When we publish our service offering, and operate to schedule, we will provide a new level of precision for our customers.

Customers have responded well to the concept of the plan, with transit times measured in hours, not days. Customers have also responded well to our goal of 90% plus on-time performance;

- **Opening of Calgary intermodal terminal expansion**
A robust Alberta economy and a 37% increase in container traffic through Calgary last year has prompted CN to invest $8.7 million to double the capacity of its Calgary intermodal terminal. This terminal is strategically positioned to serve all major centers in North America over a rail network that provides single-line service within Canada and the United States, and with access into Mexico;

- **Introduction of new electronic customs clearance systems**
CN introduced a new electronic data interchange process designed to report and clear international traffic with U.S. Customs and Canada Customs more efficiently. Rail shipments cross the border in either direction without delay, resulting in shorter transit times, improved customs reliability and reduced costs;

- **Opening of new Network Operations Center**
The Company opened its new Network Operations Center in Edmonton. The facility is CN's nerve center for train movements across North America. It is equipped with the best technology and communications facilities available, ensuring reliable and consistent service for the Company's customers;

- **Opening of new Metals Distribution Center**
CN opened its new Metals Distribution Center north of Toronto in Concord, Ontario. This 65,000-square-foot, temperature-controlled facility offers customers transfer and storage services for a variety of metal products used in the automotive industry, appliance manufacturing and construction markets. The Metals Distribution Center offers customers quick turnaround times in the highly competitive steel market. Distribution centers are playing an increasingly important role as metal producers specialize in their product lines and customers seek one-stop shopping and flexibility to order small quantities. Steel and aluminum products are transloaded between railcars and trucks for delivery to the final destination;

- **Conclusion of haulage agreement with Wisconsin Central Transportation Corporation**
CN and two operating subsidiaries of Wisconsin Central Transportation Corporation (WC) have concluded a long-term agreement under which WC will provide haulage services for CN's carload and bulk commodity trains between Superior, Wis., and Chicago, Ill. The agreement is for not less than 20 years and is renewable. The agreement calls for accelerated running times, includes a performance-based fee structure and provides for WC to make capacity improvements in the Superior-Chicago corridor;

- **Haulage agreement reached between CN and BC Rail**
This haulage agreement is to expand the market reach of grain originating at Dawson Creek and Fort St. John, B.C. and destined for export from the ports of Prince Rupert and Vancouver. The haulage agreement applies to grain traffic originating on one carrier's line but carried over the other railroad's line before reaching either Prince Rupert or Vancouver; and

- **Network rationalization program**
CN's goal, announced during the IPO, was to rationalize its system by restructuring 6,000 miles of track, while creating an efficient short-line railroad feeder network. In 1998, approximately 1,500 miles of track were restructured, bringing the total to date to nearly 5,300 miles. The following transactions were concluded in 1998:

  Grande Prairie, Grande Cache and Smoky Subdivisions – 364 miles of track, located north of Jasper, Alberta, serving shippers in the coal, forest, industrial products and grain industries, were transferred to Genesee Rail-One;

  Coronado, Bonnyville and Lac La Biche Subdivisions – 245 miles of track located northeast of Edmonton, serving shippers in the grain, forest products and chemical industries, were transferred to RaiLink, Ltd.;

  Matane, Mont-Joli and Montmagny Subdivisions – 132 miles of track linking Matane to Rivière-du-Loup, Quebec, serving shippers in the aluminum, forest products and newsprint industries, were transferred to the Quebec Railway Corporation; and

  Guelph and Fergus Subdivisions – 103 miles of track between Silver, near Brampton, and London, Ontario, serving shippers in the chemical and automotive industries, were transferred to RailTex Inc.

Management's discussion and analysis relates to the financial condition and results of operations of Canadian National Railway Company (CN) together with its wholly-owned subsidiaries, including Grand Trunk Corporation, which holds the investment in Illinois Central Corporation (IC). As used herein, the word "Company" means, as the context requires, CN and its subsidiaries and IC. CN's common shares are listed on the Toronto, New York and Montreal stock exchanges. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars and determined on the basis of United States generally accepted accounting principles (U.S. GAAP).

Financial results

1998 compared to 1997

The Company recorded consolidated net income of $266 million ($2.91 per share) for the year ended December 31, 1998 compared to consolidated net income of $1,040 million ($12.22 per share) in 1997. Diluted earnings per share were $2.88 for the current year compared to $12.06 for the year ended December 31, 1997.

The 1998 and 1997 results of operations included several items of a non-recurring nature, namely the 1998-special charge of $590 million ($345 million after tax) and the after-tax cumulative effect of a change in accounting policy for pension costs ($42 million) and track replacement costs ($589 million) in 1998 and 1997, respectively. The 1997 results of operations also included a gain on sale of the Company's interest in a joint venture of $21 million ($12 million after tax).

Excluding the non-recurring items, the Company recorded consolidated net income of $569 million ($6.22 per share) for 1998 compared to $439 million ($5.16 per share) in 1997. Diluted earnings per share, excluding such items, were $6.16 for the current year compared to $5.09 ($5.31 per share for income from continuing operations) in 1997.

Revenues for 1998 totaled $4,121 million, a decrease of $201 million, or 5%, from the comparable 1997 level. The decline was mainly attributable to grain and grain products and automotive. The Company undertook or accelerated several initiatives to allay the impact of the 1998 decline in traffic volumes which led to overall cost reductions of $282 million, or 8%, from 1997. The initiatives included a focus on improving asset utilization, fuel consumption and yard operations.

Operating income was $418 million for 1998 compared to $927 million in 1997, a decrease of $509 million. Excluding the 1998-special charge, operating income was $1,008 million for 1998, an increase of $81 million, or 9%, over 1997. The operating ratio, excluding the 1998-special charge, improved year-over-year from 78.6% to 75.5%.

The consolidated net income for 1998 includes several items related to the acquisition of IC, including interest expense of $117 million ($68 million after tax) as well as equity in earnings of IC of $105 million. The total impact of the interest and equity in earnings of IC had the effect of increasing the consolidated net income by $37 million for 1998.

The 1998 consolidated financial statements reflect, effective January 1, 1998, the Company's change in its accounting policy relating to accounting for pension and post-retirement benefit costs in accordance with the provisions of Statement of Financial Accounting Standards (FAS) 87, "Employers' Accounting for Pensions," FAS 106, "Employers' Accounting for Post-retirement Benefits Other than Pensions," and the adoption of Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." See Note 2 to the annual consolidated financial statements for the effects of accounting policy changes.

Revenues

Revenues for the year ended December 31, 1998 totaled $4,121 million. The decrease from 1997 was mainly attributable to grain and grain products and automotive. Revenue ton miles declined by a corresponding 6% when compared to 1997. Revenue per revenue ton mile for the year increased 1% to 3.60 cents in 1998.

Year ended December 31,	**1998**	1997	**1998**	1997	**1998**	1997
	Revenues		Revenue ton miles		Freight revenue per revenue ton mile	
	In millions				*In cents*	
Industrial products	**$ 874**	$ 863	**23,095**	22,870	**3.78**	3.77
Forest products	**851**	824	**22,977**	22,784	**3.70**	3.62
Grain and grain products	**554**	692	**18,937**	24,676	**2.93**	2.80
Coal, sulfur, and fertilizers	**644**	665	**25,830**	26,568	**2.49**	2.50
Intermodal	**762**	776	**19,913**	19,541	**3.83**	3.97
Automotive	**385**	435	**2,177**	3,095	**17.68**	14.05
Other items[1]	**51**	67	**–**	–	**–**	–
Total	**$4,121**	$4,322	**112,929**	119,534	**3.60**	3.56

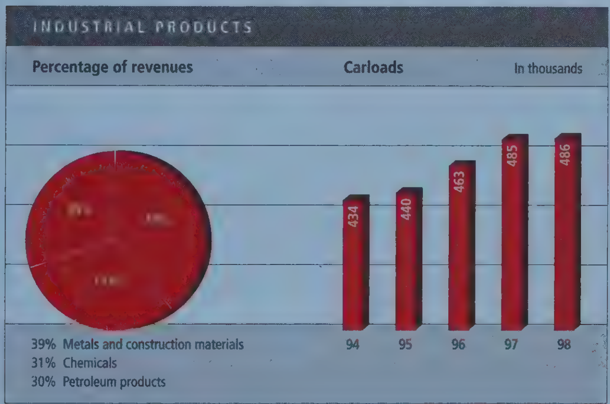
(1) Principally non-freight revenues derived from third parties.

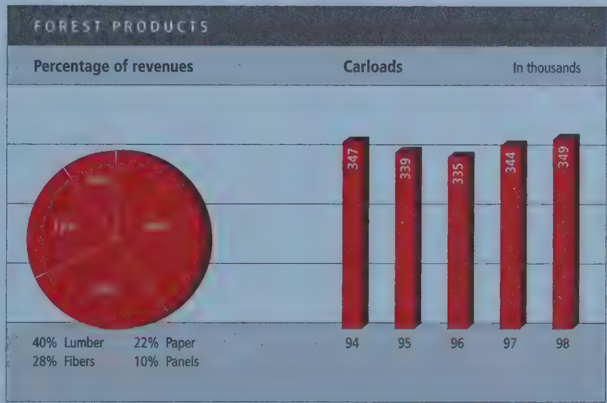
Industrial products – Revenues increased by 1% and volumes increased by 1%

Revenues increased by $11 million over 1997. The 1998 growth was largely attributable to strength in petroleum products traffic, particularly plastics and fuel oils, and in metals shipments generated by pipeline projects in western Canada, as well as an improvement in aluminum traffic as a result of strong market conditions in the United States. These gains were partially offset by softness in the chemicals markets and the impact of the Company's network rationalization program. Revenue per revenue ton mile remained relatively flat as compared to 1997.

Forest products – Revenues increased by 3% and volumes increased by 1%

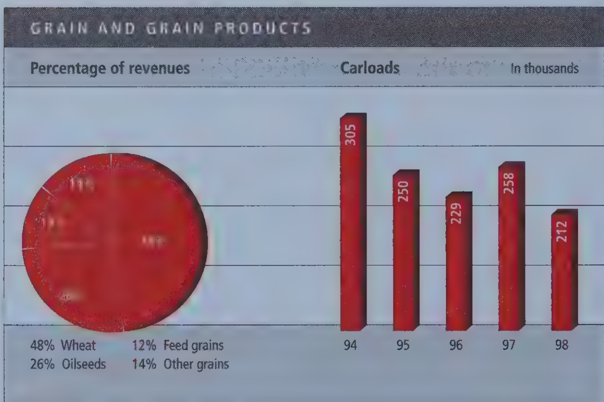
Revenues increased by $27 million over 1997. The 1998 growth was driven by increased lumber and panels traffic due to continued strength in U.S. housing activity and market share gains. Partially offsetting these increases were a six-month strike at a major North American paper producer and the impact of the Company's network rationalization program. The increase in revenue per revenue ton mile of 2% was mainly due to a shift in traffic patterns and the weakness in the Canadian dollar.





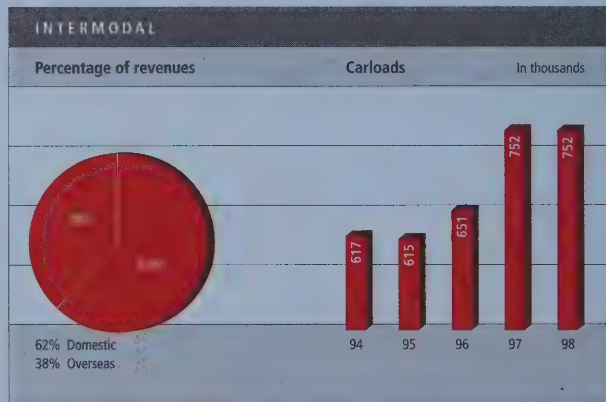
Grain and grain products – Revenues decreased by 20% and volumes decreased by 23%

Revenues decreased by $138 million from 1997. The 1998 decline reflected a very strong comparative year in 1997 due to the 1996/1997 bumper crop and softness in export markets for wheat and feed grains. Canola oil and seed shipments improved throughout the year, consistent with overall market strength. The revenue per revenue ton mile improvement of 5% was mainly due to the regulated rate increase of 2% on export grain effective August 1997, as well as a decline in longer haul export traffic.



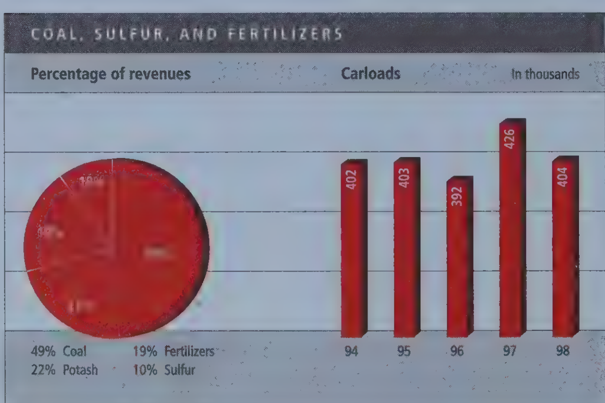
Intermodal – Revenues decreased by 2% and volumes increased by 2%

Revenues decreased by $14 million from 1997. The 1998 decline in the domestic segment was due to weaker shipments to western Canada, as well as the adverse effect of customers' concerns regarding a potential strike at the Company during labor negotiations, which were concluded in the latter part of the third quarter. Partially offsetting domestic weakness was strength in overseas traffic, particularly imports through the west coast. The decrease in revenue per revenue ton mile of 4% was largely due to a shift to longer haul traffic, particularly in the overseas market.



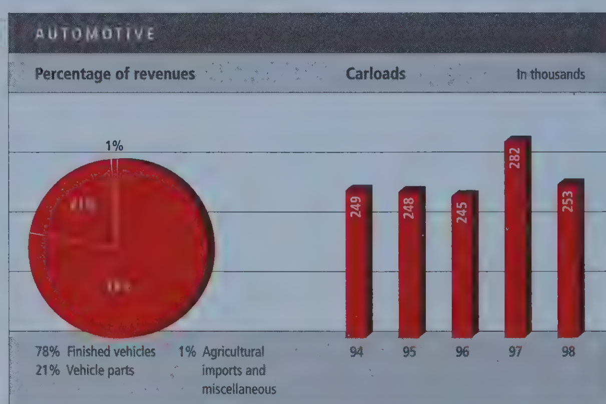
Coal, sulfur, and fertilizers – Revenues decreased by 3% and volumes decreased by 3%

Revenues decreased by $21 million from 1997. The 1998 decrease was mainly attributable to lower coal export traffic as a result of weak international coal markets, particularly from reductions in Asian steel production. Continued excess supply in the international sulfur market also contributed to the decline. Lower overall Canadian potash exports led to a decline in potash revenues partially offset by new sourcing from western Canada following a mine closure in eastern Canada. Revenue per revenue ton mile remained relatively flat as compared to 1997.



Automotive – Revenues decreased by 11% and volumes decreased by 30%

Revenues decreased by $50 million from 1997. The 1998 decline was due primarily to the impact of a June and July strike at a major U.S. automobile manufacturer, reduced production at a major Company-served auto plant due to retooling, and a corporate decision to shed unprofitable business. The increase in revenue per revenue ton mile of 26% was driven by changes in customer distribution patterns, a corporate decision to shed unprofitable business, and weakness in the Canadian dollar.



Operating expenses

Total operating expenses amounted to $3,703 million in 1998 as compared to $3,395 million in 1997. Operating expenses, excluding the special charge, amounted to $3,113 million in 1998, a decrease of $282 million, or 8%.

Dollars in millions *Year ended December 31,*	1998		1997	
	Amount	**% of revenue**	Amount	% of revenue
Labor and fringe benefits	**$1,293**	**31.4%**	$1,327	30.7%
Material	**215**	**5.2%**	262	6.1%
Fuel	**243**	**5.9%**	326	7.5%
Depreciation and amortization	**316**	**7.7%**	315	7.3%
Operating taxes	**170**	**4.1%**	186	4.3%
Equipment rental	**207**	**5.0%**	214	5.0%
Net car hire	**83**	**2.0%**	116	2.7%
Purchased services	**325**	**7.9%**	356	8.2%
Casualty and insurance	**66**	**1.6%**	70	1.6%
Other	**195**	**4.7%**	223	5.2%
	3,113	**75.5%**	3,395	78.6%
Special charge	**590**		–	
Total operating expenses	**$3,703**		$3,395	

Labor and fringe benefits: Labor and fringe benefit expenses decreased by $34 million, or 3%, during 1998. The decrease was largely attributable to lower volumes, the impact of the Company's downsizing efforts, as the average number of employees declined from 22,800 in 1997 to 21,514 in 1998, and an increase in capitalization due to a higher proportion of the workforce assigned to capital projects. Partially offsetting the decrease in labor and fringe benefits expense were wage increases and higher pension expense, mainly attributable to benefits related to the new collective agreements, as well as an adjustment to workers' compensation expense following a comprehensive study of the accounting for these costs.

Material: Costs of material consumed during 1998 were $47 million, or 18%, lower than in 1997, mainly as a result of the Company's network rationalization initiatives, the capitalization of certain costs related to locomotive refurbishments as well as the temporary closure of certain repair facilities.

Fuel: The decline in the average price of fuel of 12% (including the effects of the Company's fuel hedging program) as well as reduced volume levels and a 10% improvement in fuel efficiency largely produced a decrease in fuel expense for 1998 of $83 million, or 25%, over 1997.

Depreciation and amortization: Depreciation and amortization expense remained relatively flat in 1998 as the increased depreciation expense related to the 1998 capital additions, as well as the acquisition of new locomotives in the latter part of 1997, was offset by the effects of lower depreciation rates for certain track assets commencing in 1998.

Operating taxes: Operating taxes decreased by $16 million, or 9%, during 1998, mainly as a result of a decrease in diesel fuel taxes and municipal property taxes.

Equipment rental: These expenses decreased by $7 million, or 3%, in 1998, largely as a result of an increase in locomotive short-term lease income.

Net car hire: Car hire costs decreased by $33 million, or 28%, in 1998, due mainly to decreased car hire expenses on covered hopper grain cars, decreased volumes and improved asset utilization.

Purchased services: Costs of purchased services decreased by $31 million, or 9%, in 1998, largely as a result of lower professional fees, cost reductions on a locomotive maintenance contract, lower vehicle leasing costs and deadheading costs. This was partially offset by decreased cost recoveries related to joint facility projects and increased costs related to detouring traffic as a result of the 1998 ice storm in eastern Canada.

Casualty and insurance: These expenses decreased by $4 million, or 6%, during 1998, mainly as a result of an improved safety record, lower costs of train accidents and legal claims related to injuries to persons. The decrease was partially mitigated by a 1997 recovery from a third party.

Other: These expenses decreased by $28 million, or 13%, in 1998 compared to 1997, mainly due to the capitalization of certain costs related to information technology system development projects, decreased utility costs, higher recoveries from third parties and the write-off of certain accounts receivable in 1997.

Special charge: The Company recorded a $590-million pre-tax charge ($345 million after tax) to operations in the third quarter of 1998 for workforce reduction plans aimed at reducing future operating costs and increasing productivity. The charge includes severance and other payments to be made for approximately 3,000 reductions, 1,400 of which occurred in 1998, with the remainder planned to be completed before the end of 1999. Labor productivity and operating efficiency initiatives span the entire organization with reductions in the administration, transportation, engineering and equipment functions.

Other

Interest expense: Interest expense for the year ended December 31, 1998 was $242 million compared to $117 million in 1997, an increase of $125 million. The increase reflects the impact of the financing related to the acquisition of IC, as well as the financing related to the locomotive upgrade program and other capital leases, which was partially offset by repurchases of some of the Company's outstanding long-term debt in the latter part of 1997.

Equity in earnings of Illinois Central Corporation: The Company applies the equity method of accounting for its investment in IC. Accordingly, equity in the earnings of IC of $105 million was recorded in 1998.

Other income: Other income for the year ended December 31, 1998 was $43 million, a decrease of $19 million from 1997. The decrease was mainly due to the second-quarter 1997 gain on sale of the Company's interest in a joint venture of $21 million.

Foreign exchange loss: Effective April 1, 1998, the Company designated U.S.$1.8 billion of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Effective June 4, 1998, and corresponding with the completion of the second step of the IC acquisition, the Company increased that designated amount to include all of its U.S. dollar denominated debt. The result is that unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's U.S. dollar denominated debt, are included in Accumulated other comprehensive income, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC, which forms part of Shareholders' equity.

The Company recorded a foreign exchange loss of $26 million for 1998 compared to a loss of $38 million in 1997. The decreased foreign exchange loss resulted largely from both the effect of the changes in the value of the Canadian dollar on the Company's U.S. dollar denominated long-term debt and operations, and the Company's designation of a hedge of the net investment in IC with the U.S. dollar denominated long-term debt.

Income tax expense from continuing operations: Income tax expense for the year ended December 31, 1998 was $74 million compared to $365 million for the year ended December 31, 1997. The effective income tax rate for 1998 was affected by the Company's equity in earnings of IC. Excluding the equity in earnings of IC and the special charge, the effective income tax rate was 40.7% in 1998. The effective tax rate in 1997 was 43.8%.

1997 compared to 1996

The Company recorded a consolidated net income of $1,040 million ($12.22 per share) for the year ended December 31, 1997 compared to consolidated net income of $846 million ($9.96 per share) in 1996. Diluted earnings per share were $12.06 per share for 1997 compared to $9.85 per share in 1996.

Operating income was $927 million for the year ended December 31, 1997 compared to $223 million in 1996, an increase of $704 million. Excluding the 1996-special charge of $365 million, the operating income for the year ended December 31, 1996 was $588 million. There was a $366 million, or 9%, increase in revenues and a $27 million, or 1%, increase in operating expenses, excluding the 1996-special charge. The operating ratio, excluding the 1996-special charge, improved from 85.1% in 1996 to 78.6% in 1997, a 6.5-point betterment.

Revenues

Revenues for the year ended December 31, 1997 totaled $4,322 million, an increase of $366 million, or 9%, from the comparable 1996 level. The increase was attributable to all business units, with grain and grain products at 23%, intermodal at 15% and automotive at 12% leading the way. Revenue ton miles increased by a corresponding 11%.

Year ended December 31,	1997	1996	1997	1996	1997	1996
	Revenues		Revenue ton miles		Freight revenue per revenue ton mile	
	In millions				*In cents*	
Industrial products	$ 863	$ 827	22,870	21,698	3.77	3.81
Forest products	824	787	22,784	21,297	3.62	3.70
Grain and grain products	692	564	24,676	20,755	2.80	2.72
Coal, sulfur, and fertilizers	665	642	26,568	24,583	2.50	2.61
Intermodal	776	677	19,541	16,507	3.97	4.10
Automotive	435	389	3,095	2,630	14.05	14.79
Other items(1)	67	70	–	–	–	–
Total	$4,322	$3,956	119,534	107,470	3.56	3.62

(1) Principally non-freight revenues derived from third parties.

Industrial products – Revenues increased by 4% and volumes increased by 5%

The 1997 growth was mainly due to volume increases in the metals and petroleum products segments. Growth in the metals segment reflects market share gains, strong U.S. market demand for aluminum, and increased pipe movements to western Canada for pipeline construction and municipal development. Strong plastics demand contributed to growth in the petroleum segment. Moderate gains were made in the industrial chemical and petrochemical segments. The decline in yield of 1% resulted from traffic mix changes and the effect of the Ultratrain operation.

Forest products – Revenues increased by 5% and volumes increased by 7%

The improvement was due to increases in all forest products segments. Lumber traffic grew significantly due to a stronger U.S. housing market and successful market share gains. Growth in panels reflected the impact of various new oriented strand board mills which began production in 1996/1997. Improved market conditions and market share gains in newsprint relative to trucking contributed to the strength in the pulp and paper segment. The reduction in revenue per revenue ton mile resulted from increases in longer haul traffic.

Grain and grain products – Revenues increased by 23% and volumes increased by 19%

The improvement is due to the 1996/1997 bumper grain crop compared to the previous year, continued strength in third and fourth-quarter grain sales, and the regulated rate increases of 7.1% and 2% effective August 1996 and 1997, respectively. Revenue per revenue ton mile increased by 3%, primarily due to the rate increases, although these gains were partially offset by increases in longer haul traffic and increased haulage fees as a result of the Company's network rationalization program.

Coal, sulfur, and fertilizers – Revenues increased by 4% and volumes increased by 8%

The increase reflects growth in the potash, coal and fertilizers segments. Growth in potash revenues was primarily a result of strong demand conditions both in U.S. and offshore markets. Increases in the coal segment's revenues reflect significant gains in domestic coal movements and limited growth in coal export traffic, as well as new spot petroleum coke export moves from northern Alberta. The decline in yield of 4% was driven by changes in traffic mix in potash and coal.

Intermodal – Revenues increased by 15% and volumes increased by 18%

The increase reflects an improvement in the Company's market position as well as a strong economy generating healthy growth in domestic and, in particular, overseas market segments. The Company was able to capitalize on this growth partly as a result of on-time performance and service reliability improvements. Contributing to the yield decrease of 3% was the shift to longer haul traffic, particularly in overseas markets, and increased cartage charges.

Automotive – Revenues increased by 12% and volumes increased by 18%

The strength in the automotive business unit was due, in part, to double-digit growth in Canadian motor vehicle sales and moderate gains in U.S. sales. New contracts were signed for finished vehicles destined for the United States and parts traffic inbound to Ontario. The drop in revenue per revenue ton mile of 5% is attributable to a change in traffic mix.

Operating expenses

Total operating expenses amounted to $3,395 million in 1997 as compared to $3,733 million in 1996, including a special charge of $365 million. Excluding the 1996-special charge, operating expenses in 1997 increased by $27 million, or 1%, from 1996 while revenue ton miles increased by 11%.

Dollars in millions *Year ended December 31,*	1997		1996	
	Amount	% of revenue	Amount	% of revenue
Labor and fringe benefits	$1,327	30.7%	$1,404	35.5%
Material	262	6.1%	295	7.5%
Fuel	326	7.5%	314	7.9%
Depreciation and amortization	315	7.3%	193	4.9%
Operating taxes	186	4.3%	171	4.3%
Equipment rental	214	5.0%	216	5.5%
Net car hire	116	2.7%	108	2.7%
Purchased services	356	8.2%	348	8.8%
Casualty and insurance	70	1.6%	61	1.5%
Other	223	5.2%	258	6.5%
	3,395	78.6%	3,368	85.1%
Special charge	–		365	
Total operating expenses	$3,395		$3,733	

Labor and fringe benefits: These costs decreased by $77 million, or 5%, in 1997. The 1997 change in accounting policy related to track replacement costs was a major factor related to the 1997 decrease in labor and fringe benefit costs. The Company's downsizing initiatives also played a role in the decreased labor cost. Partially offsetting these decreases were major volume increases in 1997 and severe winter weather conditions in the first quarter of the same year. Labor productivity, as measured by revenue ton miles per average number of employees, improved by 17% to 5.2 million.

Material: Costs of material consumed during 1997 were $33 million, or 11%, lower than in 1996. The 1997 change in accounting policy related to track replacement costs and the Company's continued aggressive sourcing initiatives and efficiencies arising from shop consolidation were major factors related to the 1997 decrease in material expenses. Partially offsetting these decreases were increased costs associated with the severe winter conditions in early 1997 and to costs incurred under the winter readiness program in the latter part of the year.

Fuel: The combined effect of price and traffic volume increases more than offset fuel efficiency savings and the effect of the 1997 change in accounting policy related to track replacement costs, leaving a net increase in fuel costs of $12 million, or 4%, compared to 1996.

Depreciation and amortization: The 1997 change in accounting policy related to track replacement costs, as well as the acquisition of high-productivity locomotives in late 1996 and in 1997, under the locomotive upgrade program, were the main factors behind the increase of $122 million, or 63%.

Operating taxes: Increased provincial sales taxes, due to a one-time recovery in the third quarter of 1996, as well as increases in municipal and fuel taxes, accounted for the $15 million, or 9%, increase in operating taxes in 1997.

Equipment rental: Such costs decreased by $2 million, or 1%, compared with 1996 due mainly to additional short-term leases required as a result of increased volumes. This was more than offset by the acquisition of cars previously under operating leases and the 1997 change in accounting policy related to track replacement costs.

Net car hire: Car hire costs increased by $8 million, or 7%, from 1996. The increase was due primarily to additional per diem car mileage payments as a result of increased traffic volumes, mainly in intermodal.

Purchased services: Costs of purchased services increased by $8 million, or 2%, from the 1996 level, due mainly to increased expenditures for professional services and contracted repairs partially offset by the impact of the 1997 change in accounting policy related to track replacement costs.

Casualty and insurance: Costs increased by $9 million, or 15%, due mainly to increased provisions for legal claims related to injuries to persons and a 1996 $12-million recovery of insurance premiums associated with the liquidation of the Company's interest in an industry insurance association. This increase was partially mitigated by a decrease in the costs related to train accidents and the impact of the 1997 change in accounting policy related to track replacement costs.

Other

Interest expense: Interest expense was $117 million in 1997 compared to $113 million in 1996, an increase of $4 million, or 4%. This increase reflects the impact of the financing related to the locomotive upgrade program offset by the repurchase of some of the Company's outstanding long-term debt.

Other income: Other income for the year ended December 31, 1997 was $62 million compared to $41 million in 1996. The increase was due mainly to the second-quarter 1997 $21-million gain realized on the sale of the Company's joint-venture interest in Halterm Limited and other property sales.

Foreign exchange (loss) gain: Foreign exchange loss amounted to $38 million in 1997 compared to a foreign exchange gain of $3 million in 1996. The 1997 loss was due largely to the effect of changes in the value of the Canadian dollar on the Company's U.S. dollar denominated long-term debt.

Income tax (expense) recovery from continuing operations: Income tax expense was $365 million in 1997 compared to a recovery of $694 million the preceding year. In 1996, the Company reversed its previously recorded valuation allowance.

Discontinued operations: Consistent with the Company's plans to focus resources on operating a transportation network, in late 1997, the Company adopted a formal plan to exit its telecommunication business operated by a subsidiary. The loss from discontinued operations (net of applicable income taxes) which includes the current year loss, as well as a provision for future losses from the discontinued operations, amounted to $18 million for 1997. Discontinued operations (net of applicable income taxes) provided income of $14 million in 1996 due primarily to the gain on sale of CN France S.A.

Extraordinary item: The charge to operations of the costs to redeem or repurchase debt in 1996 amounted to $16 million.

Liquidity and capital resources

Operating activities: Cash provided from continuing operations was $1,237 million for the year ended December 31, 1998 compared to $921 million for 1997. Cash from continuing operations includes proceeds of $219 million received as a result of the Company's sale of accounts receivable. Income from continuing operations, excluding non-cash items, generated cash of $1,110 million in 1998, down from $1,158 million in 1997. A significant portion of the cash generated in 1998 was consumed by payments with respect to workforce reductions of $187 million. As a result of these payments, as well as the 1998 workforce reduction pre-tax special charge of $590 million, which includes $36 million related to a pension curtailment, the workforce reduction accruals have been increased to $825 million as at December 31, 1998. Cash payments with respect to workforce reductions are expected to be approximately $235 million in 1999.

Cash tax payments were $18 million for the year ended December 31, 1998, consisting primarily of Canadian Federal Large Corporations Tax. As at December 31, 1998, the Company had net loss carryforwards and other temporary differences for Canadian federal tax purposes such that it does not expect to make any significant cash payments for Canadian federal income taxes prior to 2000.

Investing activities: Cash used in investing activities in 1998 amounted to $3,299 million, net of proceeds from disposals of $54 million. Investing activities include $2,608 million related to the first-step acquisition of 75% of the outstanding shares of IC capital stock in March 1998. Capital expenditures, excluding items financed under capital leases, amounted to $744 million in the year ended December 31, 1998, an increase of 22% over 1997. Capital expenditures included roadway renewal, rolling stock and other capacity and productivity improvements. The Company anticipates that capital expenditures for 1999 will be approximately $700 million, excluding capital expenditures of IC and capital expenditures related to the integration of CN and IC. This will include funds required for ongoing renewal of the basic plant and other acquisitions and investments required to improve the Company's operating efficiency and customer service.

As at December 31, 1998, the Company had commitments to acquire locomotives and freight cars at a cost of $149 million, rail at a cost of $43 million, railroad ties at a cost of $44 million, automotive equipment at a cost of $15 million and intermodal equipment at a cost of $2 million.

Dividends: The Company paid four quarterly dividends to its shareholders at the rate of $0.265 per share per quarter and in the overall amount of $99 million during 1998.

Financing activities: Financing activities provided cash of $2,059 million for the year ended December 31, 1998. Issuance of long-term debt was used for the acquisition of IC common shares. The initial financing included a U.S.$800 million one-year term loan facility and a U.S.$800 million draw-down on a five-year revolving credit facility. In addition, capital lease financing was used for the acquisition of equipment, including new locomotives under the locomotive upgrade program. In June 1998, the Company initiated a commercial paper program. The Company has since fully repaid the one-year term loan facility and reduced its draw-down on the five-year revolving credit facility with proceeds from the issuance of U.S.$925 million of long-term debt and from the issuance of additional commercial paper. The commercial paper program enables the Company to issue commercial paper up to a maximum aggregate principal amount of $600 million, or the U.S. dollar equivalent, and is supported by the revolving credit facility. As at December 31, 1998, the Company had $532 million (U.S.$347 million) of commercial paper outstanding.

Acquisition of Illinois Central Corporation

If approved by the United States Surface Transportation Board (STB), the acquisition of IC will put the Company in a strong position to take advantage of growing traffic flows in key NAFTA markets by combining its east-west, coast-to-coast Canadian market strength with IC's highly efficient north-south midwest corridor from Chicago to the Gulf of Mexico.

Close of tender offer

On March 14, 1998, pursuant to a first-step cash tender offer, Blackhawk Merger Sub, Inc., a wholly-owned subsidiary of Grand Trunk Corporation, acquired 46.05 million shares of IC common stock, representing 75% of the outstanding IC common stock, for $2,549 million (U.S.$1,796 million), or U.S.$39 per IC share.

Second-step merger

On June 4, 1998, the Company and IC consummated the second-step merger by exchanging the remaining 25% of the outstanding IC common shares at an exchange ratio of 0.633 shares of the Company's common stock per IC share. As a result of the second-step merger, the remaining 25% of IC shares were exchanged for 10.1 million shares of the Company's common stock. In addition, the outstanding IC stock options were exchanged for stock options of the Company.

STB approval

On July 15, 1998, CN and IC filed a formal application with the STB seeking regulatory approval of CN's acquisition of control of IC and the integration of the companies' rail operations.

The IC shares acquired by CN pursuant to the cash tender offer and second-step merger have been placed in a voting trust pending approval of the transaction by the STB. As a result, the Company will not be able to exercise control over IC until the STB approves the Company's acquisition of control of IC. The STB could impose conditions or restrictions as it relates to the Company's acquisition of control of IC. If the STB does not approve the Company's acquisition of control of IC or if the Company deems any conditions imposed by the STB unacceptable, the Company would be obligated to sell all IC common shares held in the voting trust. Such a disposition could materially adversely affect the Company's financial condition and results of operations.

Accounting treatment

The acquisition of IC is accounted for as a purchase. Pending STB approval, the Company accounts for its investment in IC using the equity method. Upon receipt of STB approval, the financial statements of IC will be consolidated with those of the Company. The purchase price allocation will only be finalized after the STB renders its decision.

Acquisition financing

The acquisition of 75% of the outstanding common stock of IC for U.S.$1,796 million was initially financed by a U.S.$800 million one-year term loan facility (Term Facility), a U.S.$800 million draw-down on a five-year revolving credit facility (Revolving Facility), and by cash on hand.

The Term Facility was repaid and the Revolving Facility was reduced with the proceeds from the issuance of U.S.$925 million of long-term debt and the issuance of commercial paper. An amount of U.S.$220 million (Cdn$337 million) remains outstanding under the Revolving Facility as at December 31, 1998. Consequently, the acquisition financing is reflected within long-term debt.

Pro-forma impact of Illinois Central Corporation acquisition

If the Company had acquired its investment in IC on January 1, 1997, based on the historical amounts reported by IC, net of the amortization of the difference between the Company's cost to acquire IC and the underlying historical equity in net assets of IC (based on preliminary estimates of the fair value of IC's properties and equipment and estimates of their remaining useful lives, as well as estimates of the fair value of other IC assets and liabilities), income from continuing operations would have been $253 million ($2.64 per share) for the year ended December 31, 1998 (excluding special charges recorded by IC related to the merger) compared to $525 million ($5.51 per share) for 1997. Income from continuing operations would have included equity in earnings of IC of $153 million for the year ended December 31, 1998 (excluding special charges recorded by IC related to the merger), compared to $146 million for 1997. Income from continuing operations would also have included after-tax interest expense related to the acquisition of $87 million for the year ended December 31, 1998 compared to $90 million for 1997. The pro-forma figures do not reflect synergies, and accordingly, do not account for any potential increases in operating income, any estimated cost savings, facilities consolidation or adjustments to conform accounting practices.

Strategic alliance with Kansas City Southern Railway

On April 15, 1998, CN, IC and the Kansas City Southern Railway Company (KCSR) entered into a 15-year alliance that offers shippers new competitive options in a rail freight transportation network linking key north-south continental freight markets.

A marketing agreement among CN, IC and KCSR links service points in Canada with the major U.S. Midwest markets of Detroit, Chicago, Kansas City and St. Louis, along with the key southern markets of Memphis, Dallas and Houston. Under the marketing agreement, the parties coordinate sales, marketing and operations in a large number of markets and interline traffic at key gateways.

CN and KCSR also signed a separate access agreement regarding certain haulage and trackage rights under which CN and KCSR contemplate investments in automotive, intermodal and transload facilities to capitalize on the growth potential represented by the marketing agreement. The access agreement is contingent upon STB approval of CN's acquisition of control of IC.

The access agreement would give KCSR access to three chemical plants at Geismar, Louisiana, now served by IC, with associated overhead haulage rights from Geismar to Baton Rouge and, for traffic moving to or from certain eastern centers, from Baton Rouge to Jackson. KCSR access to the three Geismar plants is expected to take effect in the fall of 2000.

Under the terms of these agreements, neither CN nor KCSR will acquire equity interests or other financial holdings in the other.

Long-term agreement with Wisconsin Central

On June 15, 1998, the Company announced that CN carload and bulk commodity trains would use the Wisconsin Central route from Superior, Wisconsin to Chicago, Illinois. The agreement is for not less than 20 years and is renewable. It enables CN to use its existing capacity to increase traffic moving between western Canada and the United States. The agreement builds on an already close and mutually beneficial relationship that CN has established with Wisconsin Central.

Business risks

Certain information included in this report may be "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995. Such forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors which may cause the outlook, the actual results or performance of the Company or the rail industry to be materially different from any future results or performance implied by such statements. Such factors include the factors set forth below as well as other risks detailed from time to time in reports filed by the Company with securities regulators in Canada and the United States.

Competition

The Company faces competition from a variety of carriers, including Canadian Pacific Limited, which operates the other major rail system in Canada serving most of the same industrial and population centers as the Company, long distance trucking companies and, in certain markets, major U.S. railroads. Competition is generally based on the quality and reliability of service provided, price and the carrier's equipment. Competition is particularly intense in eastern Canada, where an extensive highway network and population centers located relatively close to one another have encouraged significant competition from trucking companies and rail network over-capacity. In addition, much of the freight carried by the Company consists of commodity goods that are available from other sources in competitive markets. Factors affecting the competitive position of suppliers of these commodities, including exchange rates, could materially affect the demand for goods supplied by the sources served by the Company and, therefore, the Company's volumes, revenues and profit margins.

IC faces significant competition for freight traffic from trucks, river barges, pipeline carriers and other railroads. Competition is generally based on the rates charged and the quality and reliability of the service provided. To a greater degree than other rail carriers, IC's principal railroad subsidiary is vulnerable to barge competition because its main routes are parallel to the Mississippi River system. The use of barges for some commodities, particularly coal and grain, often represents a lower cost mode of transportation. Barge competition and barge rates are affected by navigational interruptions from ice, floods and droughts which can cause widely fluctuating barge rates. The ability of IC's principal railroad subsidiary to maintain its market share of the available freight has traditionally been affected by the navigational conditions on the river. As a result, the revenue per ton mile of IC's principal railroad subsidiary has generally been lower than industry averages for these commodities.

In recent years, there has been significant consolidation of rail systems in the United States. The resulting larger rail systems are able to offer seamless services in larger market areas and effectively compete with the Company in certain markets. The merger of CN and IC is expected to enhance the competitive ability of CN and IC as a combined entity. There can be no assurance that the combined company will be able to compete effectively against current and future competitors in the railroad industry and that further consolidation within the railroad industry would not adversely affect CN's and IC's competitive position. No assurance can be given that competitive pressures will not lead to reduced revenues, profit margins or both.

Integration of operations

The merger of CN and IC will involve the integration of two companies that have previously operated independently, with focuses on different geographic market segments. No assurance can be given that CN will be able to integrate the operations of IC without encountering difficulties or experiencing the loss of key IC employees or customers, or that the benefits expected from such integration will be realized.

Environment

The Company's operations are subject to federal, provincial, state, municipal and local regulations under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances and other materials, decommissioning of underground and aboveground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate ownership, operation or control, and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railroad operations and relating to its past and present ownership, operation or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities.

As at December 31, 1998, the Company had aggregate accruals for environmental costs of $65 million ($76 million at December 31, 1997). The Company has not included any reduction in costs for anticipated recovery from insurance.

IC is aware of approximately 10 contaminated sites at which it is probably liable for some portion of any required clean-up. Of these, four involve contamination primarily by diesel fuel which can be remediated without material cost. Five other sites are each expected to require more than U.S.$1 million in clean-up costs. At four of these sites, other parties are expected to contribute the majority of the costs incurred. IC paid approximately U.S.$0.7 million toward the investigation and remediation at all sites in 1998 and anticipates incurring approximately U.S.$1 million to U.S.$2 million in each of the next three years. At December 31, 1998, IC estimated the probable range of its liability to be U.S.$7.5 million to U.S.$29.8 million, and in accordance with the provisions of FAS 5, "Accounting for Contingencies," had a reserve of U.S.$7.5 million for environmental contingencies. This amount is not reduced for potential insurance recoveries or third-party contributions.

Illinois Central Railroad (ICRR), IC's principal operating subsidiary, is one of several defendants in a New Orleans class action in which a jury returned a verdict against ICRR of U.S.$125 million in punitive damages as a result of a tank car fire. The Louisiana Supreme Court vacated the judgment for technical reasons and remanded the case to the trial court for further proceedings. On June 17, 1998, the trial court re-entered judgment in favor of the class and certified it for interlocutory appeal. The case awaits hearing in the trial court on post-trial motions. While the final outcome of this proceeding cannot be determined, in the opinion of IC's management, based on present information, the ultimate resolution of this case is not expected to have a material adverse effect on IC's financial position, results of operations, cash flow or liquidity.

In the operation of a railroad, it is possible that derailments, explosions or other accidents may occur that could cause harm to human health or to the environment. As a result, the Company may incur costs in the future which may be material, to address any such harm, including costs relating to the performance of clean-ups, natural resource damage and compensatory or punitive damages relating to harm to individuals or property.

Because the ultimate cost of known contaminated sites cannot be definitely established and because additional contaminated sites yet unknown may be discovered or future operations may result in accidental releases, no assurance can be given that the Company will not incur material environmental liabilities in the future.

Legal actions

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1998 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position or results of operations.

Labor negotiations

The Company's collective agreements with all Canadian unions expired on December 31, 1997. Following bargaining from late 1997 to mid-1998, all of the unionized workforce in Canada had concluded and ratified three-year collective agreements as of the end of 1998.

The Company is also in negotiation with bargaining units in the United States. The Company is currently engaged in mediation with three units. Under the mediation process, the parties are required to continue discussions until the mediator declares an impasse and releases the parties. There is no time limit on the duration of the mediation phase. If such mediation is unsuccessful, the union could commence a work stoppage as early as 30 days after the declaration of an impasse by the

mediator. A strike would likely have the effect of shutting down certain of the Company's operations for the duration of the strike. Such a strike could have a material adverse effect on the Company's financial condition and its results of operations.

Approximately 90% of IC's employees are represented by one of 11 unions. The general approach to labor negotiations by Class I railroads in the United States is to bargain on a collective national basis. For several years now, one of IC's guiding principles is that local – rather than national, industry-wide – negotiations will result in labor agreements that better address both employees' concerns and preferences, and IC's actual operating environment. To date, all of IC's principal railroad subsidiary's 11 bargaining units have ratified local agreements that resolve wage and work-rule issues through 1999 for non-operating crafts and through the year 2000 for engineers and trainmen. At CCP Holdings, Inc., labor negotiations are local as well. Maintenance-of-way, laborer and machinist employees ratified agreements in 1998. Negotiations are ongoing with bargaining units representing signal, electrician, clerical, train and engine employees. Until new agreements are reached, cost-of-living allowance provisions and other terms in previous agreements will continue. There are risks associated with negotiating locally. Presidents and Congress have repeatedly demonstrated they will step in to avoid national strikes, while local disputes may not generate federal intervention, making an extended work stoppage more likely. IC's management believes the potential mutual benefits of local bargaining outweigh the risk.

Regulation

The Company's Canadian rail operations are subject to regulation by the Canadian Transportation Agency (CTA) and the federal Minister of Transport under the CTA, the Railway Safety Act (Canada) and certain other statutes. The Company's U.S. rail operations are subject to regulation by the STB. In addition, the Company is subject to a variety of health, safety, labor, environmental and other regulations, all of which can affect its competitive position and profitability.

Year 2000 readiness disclosure

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the Year 2000 as 1900 or some other date, resulting in errors when information using Year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the Company's ability to conduct normal business operations.

Information systems are significant to the day-to-day operations of the Company. Failure to achieve Year 2000 compliance by the Company, other railroads, customers, partners or suppliers could materially adversely affect the Company's operations. In its analysis of worst case scenario, the Company is unable to predict failures in the Canadian economy. Any failure by utilities or telecommunication providers could have a material adverse effect on the financial condition and results of operations of the Company.

In 1996, the Company initiated the work to ensure that all of its computer systems are Year 2000 ready, including the identification of operating and information systems and equipment which require remedial action. The systems plan is now complete with critical traffic and support systems converted. Conversion of desktop platforms is targeted for completion in mid-1999. Detailed plans, accountability and action items are being implemented for process control, equipment, buildings, networks, end-user systems, customers, partners and suppliers. The Company has contacted its customers, partners and suppliers indicating that their Year 2000 compliance is critical in maintaining a commercial relationship. A large portion of these third parties have responded to the Company noting that their Year 2000 plans are progressing well. Furthermore, a list of critical customers, partners and suppliers has been established. Business interruption and contingency plans are either in place or under development for all critical areas, including back-up operating and information systems, alternative suppliers, increased inventory levels and sufficient lines of credit. In 1998, the Company engaged the services of independent consultants to review the management of the Year 2000 project. The conclusion was that the Company has a well planned and structured Year 2000 program effort. A second independent analysis of the Company's Year 2000 project is being conducted in early 1999 with follow-up action as necessary.

An Executive Steering Committee and Program Management Office have been established to focus all actions that must be taken to ensure the Company minimizes the risks associated with the Year 2000 issue. Progress towards Year 2000 compliance is monitored on a regular basis by the Senior Executive Committee of the Company as well as the Board of Directors. The Company has completed all critical components of the plan and no information technology projects were deferred as a result of the Year 2000 project that would have a material adverse effect on the financial condition and results of operations of the Company.

To date, the Company has expensed approximately $27 million regarding the Year 2000 project. Based on current information, the Company has estimated the total project cost to be approximately $35 million, which will continue to be expensed as incurred. The cost of the Year 2000 project is being funded from cash from operations. While there can be no assurance that all aspects of the Year 2000 issue affecting the Company, including those related to the efforts of customers, suppliers and other third parties, will be fully resolved and that the Company will not be materially adversely affected by Year 2000 problems, the Company is committed to ensuring that it is fully Year 2000 ready. Based on current information, the Company does not believe any issues relating to the Year 2000 will have a material adverse effect on its financial condition or its results from operations.

Based on recent assessments, IC determined that it will be required to modify or replace portions of its software so that its computer systems will properly utilize dates beyond December 31, 1999. IC presently believes that with modifications to existing software and conversions to new software, the Year 2000 issue can be mitigated. However, if such modifications and conversions are not made, or are delayed, the Year 2000 issue could have a material adverse impact on the operations of IC.

IC has initiated formal communications with all of its suppliers and large customers to determine the extent to which IC is vulnerable to those third parties' failure to remediate their own Year 2000 issues. There can be no guarantee that the systems of other companies on which IC's systems rely will be converted on a timely basis, or that a failure to convert by another company, or a conversion that is incompatible with IC's systems, would not have a material adverse effect on IC.

In October 1997, IC entered into an agreement to replace approximately 40% of its non-Year 2000 compliant programs with new software and will utilize both internal and external resources to replace and test the software for Year 2000 modifications. IC began converting its remaining computer systems with internal resources in 1997. IC expects to spend approximately U.S.$10 million from 1997 through 1999 to modify and replace its computer systems. Of the total project cost, approximately U.S.$3 million is attributable to the purchase of new software. IC completed conversion of non-Year 2000 compliant programs during 1998. However, user acceptance testing will continue into 1999. Installation of new software programs should be completed during the first quarter of 1999. The total cost of the project is being funded through operating cash flows. Maintenance or modification costs will be expensed as incurred, while the costs of new software will be capitalized and amortized over the software's useful life. Accordingly, IC does not expect the amounts required to be expensed over the next two years to have a material effect on its financial position or results of operations. The amount expensed in 1997 was immaterial.

The costs of the project and the date on which CN and IC plan to complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events including the continued availability of certain resources, third-party modification plans and other factors. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those plans. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties. Based on current information, the Company does not believe any issues relating to the Year 2000 will have a material adverse effect on its financial condition or its results from operations.

Financial instruments

Although the Company conducts its business and receives revenues primarily in Canadian dollars, a portion of its revenues, expenses and debt are denominated in U.S. dollars. Thus, the Company's results are affected by fluctuations in the exchange rate between these currencies. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby affect the Company's revenues.

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. The Company has entered into a forward exchange contract (currency swap) with respect to its 15-year Swiss franc bonds. This forward exchange contract acts as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred any significant net gains or losses in respect of this transaction. Losses due to non-performance by the counterparty to its foreign currency swap are not anticipated. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. However, the credit standing of counterparties is regularly monitored.

The Company uses derivative financial instruments from time to time to hedge the exposure to interest rate fluctuations on anticipated transactions.

The Company has a hedging program in place to mitigate the effects of fuel price changes on its operating margins and overall profitability. Various swaps and collar agreements are in place to mitigate the risk of fuel price volatility for which the Company has incurred costs of $17 million in 1998. Hedging positions and credit ratings of counterparties are monitored and losses due to counterparty non-performance are not anticipated. At December 31, 1998, the Company has hedged approximately 30% of the estimated 1999 fuel consumption. Unrecognized losses from the Company's fuel hedging activities amounted to $8 million as at December 31, 1998.

Other risks

In any given year, the Company, like other railroads, is susceptible to changes in the economic conditions of the industries and geographic areas that produce and consume the freight it transports. Many of the goods and commodities carried by the Company experience cyclicality in demand. However, many of the bulk commodities the Company transports move offshore and are impacted more by global economic conditions than North American economic cycles. The Company's results of operations can be expected to reflect this cyclicality because of the significant fixed costs inherent in railroad operations. The Company's revenues are affected by prevailing economic conditions, and should an economic slowdown or recession occur in North America or other key markets, the volume of rail shipments carried by the Company is likely to be reduced.

In addition to the inherent risks of the business cycle, the Company is occasionally susceptible to severe weather conditions. For example, in late 1996 and the first quarter of 1997, CN's operations in western Canada were impacted by heavy snowfalls and severe cold weather which caused blockages on the main line serving Vancouver and led to equipment failures, temporarily halting train operations. In the first quarter of 1998, a severe ice storm hit eastern Canada, which disrupted operations and service for the railroad as well as CN customers.

Generally accepted accounting principles require the use of historical cost as the basis of reporting in financial statements. As a result, the cumulative effect of inflation, which has significantly increased asset replacement costs for capital-intensive companies such as the Company, is not reflected in operating expenses. Depreciation charges on an inflation-adjusted basis, assuming that all operating assets are replaced at current price levels, would be substantially greater than historically reported amounts.

MANAGEMENT REPORT

The accompanying consolidated financial statements of Canadian National Railway Company and all information in this annual report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management in conformity with generally accepted accounting principles in the United States. These statements include some amounts that are based on best estimates and judgments. Financial information used elsewhere in the annual report is consistent with that in the financial statements.

Management of the Company, in furtherance of the integrity and objectivity of data in the financial statements, has developed and maintains a system of internal accounting controls and supports an extensive program of internal audits. Management believes that this system of internal accounting controls provides reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements, and that assets are properly accounted for and safeguarded.

The Board of Directors carries out its responsibility for the financial statements in this report principally through its Audit and Finance Committee, consisting solely of outside directors. The Audit and Finance Committee reviews the Company's annual consolidated financial statements and recommends their approval by the Board of Directors. Also, the Audit and Finance Committee meets regularly with the Chief, Internal Audit, and with the shareholders' auditors.

These consolidated financial statements have been audited by the shareholders' auditors, KPMG LLP, whose report is presented below.

Michael J. Sabia
Executive Vice-President and Chief Financial Officer

January 19, 1999

AUDITORS' REPORT

To the Board of Directors of Canadian National Railway Company

We have audited the consolidated balance sheets of Canadian National Railway Company as at December 31, 1998 and 1997 and the consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in Canada. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and 1997, and the results of its operations and the changes in its financial position for each of the years in the three-year period ended December 31, 1998, in accordance with generally accepted accounting principles in the United States.

KPMG LLP

KPMG LLP
Chartered Accountants

Montreal, Canada
January 19, 1999

In millions, except per share data — *Year ended December 31,*	**1998**	1997	1996
Revenues			
Industrial products	**$ 874**	$ 863	$ 827
Forest products	**851**	824	787
Grain and grain products	**554**	692	564
Coal, sulfur, and fertilizers	**644**	665	642
Intermodal	**762**	776	677
Automotive	**385**	435	389
Other items	**51**	67	70
Total revenues	**4,121**	4,322	3,956
Operating expenses			
Labor and fringe benefits	**1,293**	1,327	1,404
Material	**215**	262	295
Fuel	**243**	326	314
Depreciation and amortization	**316**	315	193
Operating taxes	**170**	186	171
Equipment rental	**207**	214	216
Net car hire	**83**	116	108
Purchased services	**325**	356	348
Casualty and insurance	**66**	70	61
Other	**195**	223	258
Special charges *(Note 14)*	**590**	–	365
Total operating expenses	**3,703**	3,395	3,733
Operating income	**418**	927	223
Interest expense *(Note 15)*	**(242)**	(117)	(113)
Equity in earnings of Illinois Central Corporation *(Note 3)*	**105**	–	–
Other income *(Note 16)*	**43**	62	41
Foreign exchange (loss) gain	**(26)**	(38)	3
Income from continuing operations before income taxes	**298**	834	154
Income tax (expense) recovery from continuing operations *(Note 17)*	**(74)**	(365)	694
Income from continuing operations	**224**	469	848
Discontinued operations (net of applicable income taxes) *(Note 18)*	**–**	(18)	14
Extraordinary item (net of applicable income taxes) *(Note 14)*	**–**	–	(16)
Cumulative effect of change in accounting policy (net of applicable income taxes) *(Note 2)*	**42**	589	–
Net income	**$ 266**	$1,040	$ 846
Basic earnings per share (Note 20)			
Income from continuing operations	**$ 2.45**	$ 5.51	$ 9.99
Net income	**$ 2.91**	$12.22	$ 9.96
Diluted earnings per share (Note 20)			
Income from continuing operations	**$ 2.42**	$ 5.44	$ 9.88
Net income	**$ 2.88**	$12.06	$ 9.85

See accompanying notes to consolidated financial statements.

In millions *Year ended December 31,*	**1998**	1997	1996
Net income	**$ 266**	$1,040	$ 846
Other comprehensive income:			
Unrealized foreign exchange loss on translation of U.S. dollar denominated long-term debt	**(246)**	–	–
Unrealized foreign exchange gain on translation of net investment in Illinois Central Corporation	**259**	–	–
Minimum pension liability adjustment	**(2)**	–	–
Other comprehensive income before income taxes	**11**	–	–
Income tax expense on other comprehensive income items	**(5)**	–	–
Other comprehensive income *(Note 23)*	**6**	–	–
Comprehensive income	**$ 272**	$1,040	$ 846

See accompanying notes to consolidated financial statements.

In millions December 31,	1998	1997
Assets		
Current assets:		
Cash and cash equivalents	$ 262	$ 364
Accounts receivable *(Note 5)*	399	667
Material and supplies	131	150
Deferred income taxes *(Note 17)*	131	241
Other	115	111
	1,038	1,533
Properties *(Note 6)*	6,803	6,303
Investment in Illinois Central Corporation *(Note 3)*	3,821	–
Other assets and deferred charges	290	163
Total assets	$11,952	$7,999
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable and accrued charges *(Note 8)*	$ 1,158	$1,052
Current portion of long-term debt *(Note 10)*	133	43
Other	89	83
	1,380	1,178
Deferred income taxes *(Note 17)*	327	347
Other liabilities and deferred credits *(Note 9)*	1,205	836
Long-term debt *(Note 10)*	3,995	1,628
Shareholders' equity:		
Capital stock *(Note 11)*	4,141	3,279
Accumulated other comprehensive income *(Note 23)*	6	–
Retained earnings	898	731
	5,045	4,010
Total liabilities and shareholders' equity	$11,952	$7,999

On behalf of the Board:

David G.A. McLean
Director

Paul M. Tellier
Director

See accompanying notes to consolidated financial statements.

In millions	Issued and outstanding common shares	Capital stock	Accumulated other comprehensive income	Retained earnings	Total shareholders' equity
Balances December 31, 1995	84.9	$ 3,252	$ –	$(1,009)	$ 2,243
Net income	–	–	–	846	846
Employee share plans *(Note 12)*	–	11	–	–	11
Dividends	–	–	–	(68)	(68)
Balances December 31, 1996	84.9	3,263	–	(231)	3,032
Net income	–	–	–	1,040	1,040
Stock options exercised and employee share plans *(Note 12)*	0.7	16	–	–	16
Dividends	–	–	–	(78)	(78)
Balances December 31, 1997	85.6	3,279	–	731	4,010
Net income	–	–	–	266	266
Shares issued in second-step acquisition of Illinois Central Corporation *(Note 3)*	10.1	824	–	–	824
Stock options issued in second-step acquisition of Illinois Central Corporation *(Note 3)*	–	25	–	–	25
Stock options exercised and employee share plans *(Note 12)*	0.2	13	–	–	13
Other comprehensive income *(Note 23)*	–	–	6	–	6
Dividends	–	–	–	(99)	(99)
Balances December 31, 1998	**95.9**	**$ 4,141**	**$ 6**	**$ 898**	**$5,045**

See accompanying notes to consolidated financial statements.

In millions *Year ended December 31,*	**1998**	1997	1996
Operating activities			
Income from continuing operations and cumulative effect of change in accounting policy and extraordinary item	**$ 266**	$1,058	$ 832
Non-cash items in income:			
Special charges *(Note 14)*	**590**	–	365
Cumulative effect of change in accounting policy *(Note 2)*	**(42)**	(589)	–
Foreign exchange loss (gain)	**26**	38	(3)
Depreciation and amortization *(Note 19 (D))*	**319**	317	195
Deferred income taxes *(Note 17)*	**56**	355	(705)
Equity in earnings of Illinois Central Corporation *(Note 3)*	**(105)**	–	–
Gain on sale of interest in joint venture	**–**	(21)	–
Changes in:			
Accounts receivable *(Note 5)*	**267**	5	47
Material and supplies	**19**	6	16
Accounts payable and accrued charges *(Note 8)*	**65**	18	143
Other net current assets and liabilities	**(3)**	(54)	7
Payments for workforce reduction	**(187)**	(197)	(307)
Other	**(34)**	(15)	6
Cash provided from continuing operations	**1,237**	921	596
Investing activities			
Net additions to properties *(Note 19 (D))*	**(744)**	(609)	(291)
Net proceeds from disposal of properties	**54**	63	64
Net proceeds from sale of interest in joint venture	**–**	23	–
Investment in Illinois Central Corporation *(Note 3)*	**(2,608)**	–	–
Other	**(1)**	9	(43)
Cash used by investing activities	**(3,299)**	(514)	(270)
Dividends paid to shareholders	**(99)**	(78)	(68)
Financing activities			
Issuance of long-term debt	**4,589**	13	–
Reduction of long-term debt	**(2,543)**	(80)	(293)
Issuance of capital stock *(Note 12)*	**13**	16	11
Cash provided from (used by) financing activities	**2,059**	(51)	(282)
Cash (used by) provided from discontinued operations *(Note 18 (C))*	**–**	(20)	10
Net (decrease) increase in cash	**(102)**	258	(14)
Cash and cash equivalents, beginning of year	**364**	106	120
Cash and cash equivalents, end of year	**$ 262**	$ 364	$ 106

See accompanying notes to consolidated financial statements.

CN's revenues are derived from the movement of a balanced and diversified mix of commodities and products predominantly originating in Canada. The Company's network extends from Halifax to Vancouver and connects to the Chicago gateway through its subsidiary, Grand Trunk Corporation. Illinois Central Corporation's network extends from Chicago, where it connects with the Company's network, to the Gulf of Mexico.

1 Summary of significant accounting policies

Except where otherwise indicated, these consolidated financial statements are expressed in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses during the period, the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from these estimates.

A. Principles of consolidation

These consolidated financial statements include the accounts of all subsidiaries, except for those of Illinois Central Corporation (IC), which is accounted for using the equity method pending approval of control by the U.S. Surface Transportation Board (STB). The Company's investments, in which it has significant influence, are also accounted for using the equity method.

B. Revenues

Freight revenues are recognized based on the percentage of completed service method. Costs associated with movements are recognized as the service is performed.

C. Foreign exchange

The Company's U.S. operations, excluding the Company's equity investment in IC, are classified as integrated with the Canadian dollar as the functional currency and are translated into Canadian dollars and accounted for on the following basis: monetary assets and liabilities are translated at the rates in effect at the balance sheet date; non-monetary assets and liabilities are translated at historical exchange rates; revenues and expenses are translated at average exchange rates during the year except for depreciation, which is translated at exchange rates prevailing when the related properties were acquired; and other currency gains and losses are reflected in net income for the year. The Company's own foreign denominated assets and liabilities are accorded similar treatment.

The Company's equity investment in IC, considered a self-sustaining foreign entity with the U.S. dollar as its functional currency, is translated into Canadian dollars at the rate in effect at the balance sheet date. The equity in earnings of IC is translated at average exchange rates during the year.

The Company has designated all of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's U.S. dollar denominated debt, are included in Accumulated other comprehensive income, which forms part of Shareholders' equity, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC.

D. Cash and cash equivalents

Cash and cash equivalents include highly liquid investments purchased three months or less from maturity and are stated at cost, which approximates market value.

E. Material and supplies

The inventory is valued at weighted-average cost for ties and rails, latest invoice price for fuel and new materials in stores, and at estimated utility or sales value for usable secondhand, obsolete and scrap materials.

F. Properties

Railroad properties are carried at cost less accumulated depreciation including asset impairment write-downs. All costs of labor, materials and other costs associated with the installation of rail, ties, ballast and other track improvements are capitalized to the extent they meet the Company's definition of "unit of property." Additions to other property and equipment include the cost of developing computer software for internal use. Maintenance costs are expensed as incurred.

The cost of railroad properties, less salvage value, retired or disposed of in the normal course of business, is charged to accumulated depreciation, in accordance with the group method of depreciation. Losses resulting from significant line sales or abandonments are recognized upon the announcement of the disposition. Gains are recognized when they are realized. The Company reviews the carrying amounts of properties whenever events or changes in circumstances indicate that such carrying amounts may not be recoverable based on future undiscounted cash flows or estimated net realizable value. Assets that are deemed impaired as a result of such review are recorded at the lower of carrying amount or fair value.

G. Depreciation

The cost of properties, net of asset impairment write-downs, is depreciated on a straight-line basis over their estimated useful lives as follows:

Asset class	Annual rate
Track and roadway	2%
Buildings	3%
Rolling stock	3%
Other	2%

The Company performs periodic reviews of its depreciation rates. Adjustments to rates resulting from such reviews have not had a material impact on operating results.

H. Pensions

Pension costs are determined periodically by independent actuaries. Pension expense is charged to operations and includes:

(i) the cost of pension benefits provided in exchange for employees' services rendered during the year,

(ii) the amortization of the initial net transition obligation on a straight-line basis over the expected average remaining service life of the employee group covered by the plans,

(iii) the amortization of past service costs and amendments over the expected average remaining service life of the employee group covered by the plans, and

(iv) the interest cost of pension obligations, the return on pension fund assets, and the amortization of cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the projected benefit obligation or market-related value of plan assets over the expected average remaining service life of the employee group covered by the plans.

The pension plans are funded through contributions determined in accordance with the projected unit credit actuarial cost method.

I. Post-retirement benefits other than pensions

The Company accrues the cost of post-retirement benefits other than pensions, which include life insurance programs, medical benefits, supplemental pension allowances, and free rail travel benefits not covered in the Company's principal pension plans. The Company funds the benefits payable as they become due.

The Company amortizes the cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the projected benefit obligation or market-related value of plan assets over the expected average remaining service life of the employee group covered by the plans.

J. Financial instruments

Derivative financial instruments may be used from time to time by the Company in the management of its fuel, interest rate and foreign currency exposures. Gains or losses on such instruments entered into for the purposes of hedging financial risk exposures are deferred and amortized in the results of operations over the life of the hedged asset or liability or over the terms of the derivative financial instrument. Income and expense related to financial instruments are recorded in the same category as that generated by the underlying asset or liability.

K. Environmental expenditures

Environmental expenditures that relate to current operations are expensed or capitalized as appropriate. Expenditures that relate to an existing condition caused by past operations, and which are not expected to contribute to current or future revenue generation, are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are likely, and when the costs, based on a specific plan of action in terms of the technology to be used and the extent of the corrective action required, can be reasonably estimated.

L. Income taxes

The Company follows the asset and liability method for accounting for income taxes. Under the asset and liability method, the change in the net deferred tax asset or liability is included in income. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled.

2 Accounting changes

A. Pensions and post-retirement benefits other than pensions

Effective January 1, 1998, the Company changed its accounting policy for pension costs and adopted the corridor approach to account for experience gains and losses, as described in Statement of Financial Accounting Standards (FAS) 87, "Employers' Accounting for Pensions," and FAS 106, "Employers' Accounting for Post-retirement Benefits Other than Pensions," thereby conforming the Company's accounting practices with general industry practice. Accordingly, experience gains and losses within the specified corridor were not amortized in 1998. For the year ended December 31, 1997, pension expense and post-retirement costs included $10 million of amortization of net experience losses ($8 million in 1996). The cumulative effect of the change in accounting policy was $42 million (net of applicable income taxes) as at January 1, 1998.

B. Computer software costs

In the first quarter of 1998, the Company adopted Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." In accordance with the requirements of this statement, this change has been applied prospectively. The impact of the adoption of SOP 98-1 was to increase net income by approximately $13 million for the year ended December 31, 1998.

C. Comprehensive income

Effective in 1998, the Company adopted FAS 130, "Reporting Comprehensive Income." This statement requires that all items that are required to be recognized under accounting standards as components of Comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements.

D. Pensions and post-retirement benefits other than pensions – Disclosure

Effective in 1998, the Company adopted FAS 132, "Employers' Disclosures about Pensions and Other Post-retirement Benefits." This statement revises employers' disclosures about pension and other post-retirement benefit plans. It does not change the measurement or recognition of these plans. It standardizes the disclosure requirements for pensions and other post-retirement benefits to the extent practicable and requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis.

2 Accounting changes *(continued)*

E. Properties

Effective January 1, 1997, the labor, material and related overheads of track replacement costs are capitalized, thereby conforming the Company's accounting practices with the industry practice. The cumulative capitalization adjustment of $589 million (net of applicable income taxes) is reflected in 1997 net income.

3 Acquisition of Illinois Central Corporation

On February 10, 1998, the Company, through an indirect wholly-owned subsidiary, and IC entered into a merger agreement as subsequently amended on March 4, 1998, providing for the acquisition of IC by the Company for a purchase price of approximately U.S.$2.4 billion payable as to 75% in cash and 25% in common shares of the Company. Under the terms of the agreement, on March 14, 1998, the Company acquired, pursuant to the first-step cash tender offer, approximately 46.05 million common shares or 75% of the outstanding common shares of IC for $2,549 million (U.S.$1,796 million) or U.S.$39 per share. On June 4, 1998, the Company and IC consummated the second-step merger by exchanging the remaining 25% of the outstanding common shares of IC at an exchange ratio of 0.633 shares of the Company's common stock per IC share. As a result of the second-step merger, the remaining 25% of IC shares were exchanged for 10.1 million shares of the Company's common stock. In addition, the outstanding IC stock options were exchanged for stock options of the Company.

The cash tender offer was initially financed by a U.S.$800 million one-year term loan facility, a U.S.$800 million draw-down on a five-year revolving credit facility and cash on hand. On April 24, 1998, the Company repaid U.S.$70 million (Cdn$100 million) of the revolving credit facility with cash on hand. In June 1998, the Company issued commercial paper, backed by the revolving credit facility, for U.S.$150 million (Cdn$220 million) of which U.S.$140 million (Cdn$199 million) was used to repay a portion of the revolving credit facility. In July 1998, the Company repaid the one-year term loan facility and reduced its draw-down on the five-year revolving credit facility with proceeds from the issuance of U.S.$925 million of long-term debt and from the issuance of additional commercial paper.

The shares purchased under the cash tender offer and the shares acquired in the second-step merger were placed in a voting trust pending approval by the STB of the Company's acquisition of control of IC. The STB approval, while expected, cannot be assumed and may not be granted prior to the second quarter of 1999. Upon completion of the change in control, the Company may incur certain costs which will be charged to income.

The Company accounts for its investment in IC under the equity method of accounting in accordance with Accounting Principles Board Opinion (APB) 18, "The Equity Method of Accounting for Investments in Common Stock." IC is considered a self-sustaining foreign entity with the U.S. dollar as its functional currency. Effective April 1, 1998, the Company designated U.S.$1.8 billion of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Effective June 4, 1998, and corresponding with the completion of the second step of the IC acquisition, the Company increased that designated amount to include all of its U.S. dollar denominated debt. The result is that unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's U.S. dollar denominated debt, are included in Accumulated other comprehensive income, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC, which forms part of Shareholders' equity.

The investment in IC at December 31, 1998 includes an investment of $3,398 million related to the acquisition of IC shares pursuant to the cash tender offer and the second-step merger, $259 million related to the translation of the investment to its current Canadian dollar equivalent, $59 million for transaction-related expenses, and $105 million of equity in the earnings of IC since the date of acquisition.

The Consolidated Statement of Income for the year ended December 31, 1998 includes various items related to the acquisition of IC, including $117-million pre-tax interest costs on debt associated with financing the cash tender offer. The $105-million equity in the earnings of IC included in the Consolidated Statement of Income for the year ended December 31, 1998 represents the Company's portion of IC's earnings from March 14, 1998, net of the amortization of the U.S.$1,800 million difference between the Company's cost to acquire IC and the underlying historical equity in net assets of IC, based on preliminary estimates of the fair values of IC's properties and equipment, and estimates of their remaining useful lives, as well as estimates of the fair values of other IC assets and liabilities. In total, items related to the IC acquisition increased net income for the year ended December 31, 1998 by $37 million. These amounts, as well as the impact of the issuance of shares pursuant to the second-step merger, increased the earnings per share by $0.27 for the year ended December 31, 1998. Excluding the 1998-special charge, the earnings per share increased by $0.01. The impact of the results of the final valuation of IC's assets and liabilities and changes in accounting practices are not expected to have a material impact on the results of operations.

If the Company had acquired its investment in IC on January 1, 1997, based on the historical amounts reported by IC, net of the amortization of the difference between the Company's cost to acquire IC and the underlying historical equity in net assets of IC (based on preliminary estimates of the fair values of IC's properties and equipment, and estimates of their remaining useful lives, as well as estimates of the fair values of other IC assets and liabilities), income from continuing operations would have been $253 million ($2.64 per share) for the year ended

December 31, 1998 (excluding special charges recorded by IC related to the merger) compared to $525 million ($5.51 per share) for 1997. Income from continuing operations would have included equity in earnings of IC of $153 million for the year ended December 31, 1998 (excluding special charges recorded by IC related to the merger), compared to $146 million for 1997. Income from continuing operations would also have included after-tax interest expense related to the acquisition of $87 million for the year ended December 31, 1998 compared to $90 million for 1997. The pro-forma figures do not reflect synergies, and accordingly, do not account for any potential increases in operating income, any estimated cost savings, facilities consolidation or adjustments to conform accounting practices.

4 Illinois Central Corporation consolidated financial information

Summary financial information for IC, on its historical cost basis, for the years ended December 31, 1998, 1997 and 1996, and as at December 31, 1998 and 1997, as provided by IC's management, is presented below:

Illinois Central Corporation
Condensed Consolidated Statement of Income

In millions of U.S.$ *Year ended December 31,*	**1998**	1997	1996
Revenues	**$728.8**	$699.8	$657.5
Operating expenses	**521.2**	435.9	416.3
Operating income	**207.6**	263.9	241.2
Other income	**9.3**	6.0	8.6
Interest expense	**(41.2)**	(40.0)	(34.1)
Income before income taxes	**175.7**	229.9	215.7
Income tax expense	**(70.1)**	(79.7)	(79.1)
Net income	**$105.6**	$150.2	$136.6

Operating expenses for the year ended December 31, 1998 included special charges of U.S.$48.5 million (U.S.$41.2 million after tax) for severance and other costs related to the merger.

Illinois Central Corporation
Condensed Consolidated Balance Sheet

In millions of U.S.$ *December 31,*	**1998**	1997
Assets		
Current assets	**$ 249.9**	$ 199.2
Non-current assets	**1,923.9**	1,810.2
Total assets	**$2,173.8**	$2,009.4
Liabilities and stockholders' equity		
Current liabilities	**$ 297.0**	$ 255.1
Long-term debt	**557.3**	572.2
Deferred taxes	**442.8**	409.2
Other liabilities	**130.2**	130.1
Stockholders' equity	**746.5**	642.8
Total liabilities and stockholders' equity	**$2,173.8**	$2,009.4

5 Accounts receivable

In millions *December 31,*	**1998**	1997
Freight		
Trade	**$217**	$504
Accrued	**48**	43
Non-freight	**175**	164
	440	711
Provision for doubtful accounts	**(41)**	(44)
	$399	$667

On June 25, 1998, the Company entered into a revolving agreement to sell eligible freight trade receivables. The agreement, which expires in June 2003, allows for sales of freight trade receivables up to a maximum of $250 million. At December 31, 1998, $150 million and U.S.$45 million (Cdn$69 million) had been sold on a limited recourse basis, pursuant to the agreement. The Company has retained the responsibility for servicing and collecting the accounts receivable sold. Costs related to the agreement, which fluctuate with changes in prevailing interest rates, are included in Other income.

6 Properties

In millions	***December 31, 1998***			*December 31, 1997*		
	Cost	**Accumulated depreciation**	**Net**	Cost	Accumulated depreciation	Net
Track and roadway	**$10,640**	**$5,646**	**$4,994**	$10,263	$5,627	$4,636
Buildings	**964**	**627**	**337**	920	616	304
Rolling stock	**2,303**	**1,062**	**1,241**	2,248	1,073	1,175
Other	**717**	**486**	**231**	679	491	188
	$14,624	**$7,821**	**$6,803**	$14,110	$7,807	$6,303
Capital leases included in properties	**$ 620**	**$ 72**	**$ 548**	$ 505	$ 50	$ 455

7 Credit facilities

In connection with the acquisition of IC, the Company entered into a U.S.$800 million one-year term loan facility and a U.S.$1,000 million five-year revolving credit facility. Concurrently, the Company terminated its previous revolving credit facilities. The credit facilities provide for interest on borrowings at various interest rates including the Canadian prime rate, bankers' acceptance rates, the U.S. federal funds effective rate and the London Interbank Offer Rate plus applicable margins. The credit facility agreements contain customary financial covenants, based on U.S. generally accepted accounting principles, including i) limitations on debt as a percentage of total capitalization, ii) maintenance of tangible net worth above predefined levels and iii) maintenance of the fixed charge coverage ratio above predefined levels. The Company was in compliance with all of these financial covenants throughout the year. In July 1998, the Company repaid the one-year term loan facility and reduced its draw-down on the five-year revolving credit facility with proceeds from the issuance of U.S.$925 million of long-term debt and from the issuance of commercial paper. The Company's commercial paper program is backed up by the five-year revolving credit facility. As at December 31, 1998, the Company had U.S.$347 million (Cdn$532 million) of commercial paper outstanding and U.S.$220 million (Cdn$337 million) outstanding under the revolving credit facility.

8 Accounts payable and accrued charges

In millions *December 31,*	**1998**	1997
Trade payables	**$ 263**	$ 306
Current portion of workforce reduction provisions	**235**	177
Payroll-related accruals	**177**	168
Accrued charges	**121**	119
Accrued interest on long-term debt	**111**	46
Accrued operating leases	**85**	112
Other	**166**	124
	$1,158	$1,052

9 Other liabilities and deferred credits

In millions *December 31,*	**1998**	1997
Workforce reduction provisions, net of current portion *(A)*	**$ 590**	$281
Accrual for post-retirement benefits other than pensions *(B)*	**145**	135
Personal injury reserve	**108**	88
Environmental reserve, net of current portion	**38**	59
Deferred credits and other	**324**	273
	$1,205	$836

A. Workforce reduction provisions

The workforce reduction provisions, which cover employees in both Canada and the United States, are mainly comprised of severance payments which will be disbursed over a period of up to six years. Other elements of the provisions mainly include early retirement incentives and bridging to early retirement. Payments for severance and other elements of the provisions have reduced the provisions by $187 million for the year ended December 31, 1998 ($197 million for the year ended December 31, 1997). The special charge recorded in 1998 with respect to workforce reductions, excluding the related pension curtailment, had the effect of increasing the aggregate provisions to $825 million at December 31, 1998.

B. Post-retirement benefits other than pensions

(i) Change in benefit obligation

In millions *Year ended December 31,*	**1998**	1997
Benefit obligation at beginning of year	**$132**	$126
Service cost	**4**	3
Interest cost	**11**	7
Foreign currency changes	**2**	–
Actuarial loss	**30**	3
Benefits paid	**(7)**	(7)
Benefit obligation at end of year	**$172**	$132

(ii) Funded status

In millions *December 31,*	**1998**	1997
Unfunded benefit obligation at end of year	**$172**	$132
Unrecognized net actuarial (loss) gain	**(22)**	9
Unrecognized prior service cost	**(5)**	(6)
Accrued benefit cost for post-retirement benefits other than pensions	**$145**	$135

(iii) Components of net periodic benefit cost

In millions *Year ended December 31,*	**1998**	1997	1996
Service cost	**$ 4**	$ 3	$ 3
Interest cost	**11**	7	6
Amortization of prior service cost	**1**	1	1
Recognized net actuarial loss (gain)	**1**	(2)	(8)
Net periodic benefit cost	**$17**	$ 9	$ 2

(iv) Weighted-average assumptions

December 31,	**1998**	1997	1996
Discount rate	**6.00%**	7.44%	8.00%
Rate of compensation increase	**4.25%**	4.50%	5.25%

The effect of a one-percentage-point increase or decrease in the assumed health care cost trend would be to increase or decrease the 1998 post-retirement benefit obligation by approximately $4 million.

10 Long-term debt

In millions	Maturity	Currency in which payable	December 31, 1998	1997
Bonds, debentures, and notes: (A) (B)				
Canadian National series:				
9⅝% 7-year notes	May 14, 1999	Cdn$	$ 50	$ 50
5⅜% 15-year Swiss franc bonds *(C)*	Aug. 22, 2000	CHF	99	99
8⅞% 15-year notes	May 21, 2001	Cdn$	150	150
6⅝% 10-year notes	May 15, 2003	U.S.$	190	190
7% 10-year notes	Mar. 15, 2004	U.S.$	365	365
6.45% Puttable Reset Securities (PURS) *(D)*	July 15, 2006	U.S.$	355	–
6.80% 20-year notes *(E)*	July 15, 2018	U.S.$	284	–
7⅝% 30-year debentures	May 15, 2023	U.S.$	190	190
6.90% 30-year notes *(E)*	July 15, 2028	U.S.$	674	–
Total bonds, debentures, and notes			2,357	1,044
Other: (A)				
Revolving credit facility *(Note 7)*		U.S.$	312	–
Commercial paper *(F)*		U.S.$	493	–
Amounts owing under equipment agreements *(G)*		Various	65	75
Capital lease obligations *(H)*		Various	578	480
Adjustment to current exchange rate *(A)*			331	75
Total other			1,779	630
Subtotal			4,136	1,674
Less:				
Current portion of long-term debt			133	43
Net unamortized discount			8	3
			141	46
			$3,995	$1,628

A. U.S. dollar denominated long-term debt amounts are reflected in Canadian dollars at the rate in effect at the time of the issuance of the long-term debt. The effect of the current exchange rate conversion is included in "Adjustment to current exchange rate."

B. The Company's bonds, debentures, and notes are unsecured.

C. The August 22, 2000 bonds issued in Swiss francs (CHF170 million), bearing an interest rate of 5⅜%, were effectively converted at their issue date to a $99-million Canadian dollar obligation through a currency swap agreement at an all-inclusive cost of 11.17%.

D. The PURS contain imbedded simultaneous put and call options at par. At the time of issuance, the Company sold the option to call the securities on July 15, 2006 (the reset date). If the call option is exercised, the imbedded put option is automatically triggered, resulting in the redemption of the original PURS. The call option holder will then have the right to remarket the securities at a new coupon rate for an additional 30-year term ending July 15, 2036. The new coupon rate will be determined according to a pre-set mechanism based on market conditions then prevailing. If the call option is not exercised, the put option is deemed to have been exercised, resulting in the redemption of the PURS on July 15, 2006.

E. The 20-year and 30-year notes are redeemable, in whole or in part, at the option of the Company, at any time, at the greater of par and a formula price based on interest rates prevailing at the time of redemption.

F. During 1998, the Company initiated a commercial paper program. The program enables the Company to issue commercial paper up to a maximum aggregate principal amount of $600 million or the U.S. dollar equivalent and is supported by the revolving credit facility. Commercial paper debt is due within one year but has been classified as long-term debt, reflecting the Company's intent and ability to refinance the short-term borrowing through subsequent issuances of commercial paper or drawing down on the revolving credit facility.

G. These agreements are secured by rolling stock and payable by monthly or semi-annual installments over various periods to 2003 at interest rates ranging from 6% to 13¾%. The principal amounts are payable as follows: $44 million and U.S.$16 million (Cdn$25 million) as at December 31, 1998, and $49 million and U.S.$19 million (Cdn$28 million) as at December 31, 1997.

10 Long-term debt *(continued)*

H. Interest rates for these leases range from approximately 4¾% to 14¼% with maturity dates in the years 1999 through 2016. The imputed interest on these leases amounted to $530 million as at December 31, 1998, and $460 million as at December 31, 1997.

I. Principal repayments for the following fiscal years, including repurchase arrangements and capital lease repayments on debt outstanding as at December 31, 1998 but excluding repayments of commercial paper of $532 million (U.S.$347 million) and amounts related to the revolving credit facility of $337 million (U.S.$220 million), are as follows:

Year	*In millions* Amount
1999	$ 133
2000	178
2001	214
2002	9
2003	245
2004 and thereafter	2,480

J. The aggregate amount of debt payable in U.S. currency as at December 31, 1998 is U.S.$2,343 million (Cdn$3,590 million) and as at December 31, 1997 is U.S.$800 million (Cdn$1,143 million).

K. During 1998, the Company recorded $156 million in capital lease obligations ($213 million in 1997) related to rolling stock financing.

11 Capital stock

A. Authorized capital stock

The authorized capital stock of the Company is as follows:

- Unlimited number of Common Shares, without par value
- Unlimited number of Class A Preferred Shares, without par value issuable in series
- Unlimited number of Class B Preferred Shares, without par value issuable in series

B. Issued and outstanding common shares

During 1998, the Company issued 10.1 million common shares as a result of the second-step merger with IC. The Company also issued 0.2 million shares related to stock options exercised and employee share plans. The total number of common shares issued and outstanding was 95.9 million as at December 31, 1998.

12 Stock plans

A. Employee share plans

(i) As part of the public offering in 1995, eligible employees purchased shares under the employee share plans. The Company provided non-interest bearing loans of up to 90% of the share purchase price to eligible employees. During 1998, the Company issued a total of 47,778 common shares (matched shares) to those employees whose shares in the plans had vested during the year. An additional 22,506 common shares will be issued by the Company once their vesting requirements are met.

(ii) Effective September 1, 1997, an Employee Share Investment Plan (ESIP) was implemented giving eligible employees the opportunity to subscribe for up to 6% of their gross salaries to purchase shares of the Company's common stock on the open market and to have the Company invest, on the employee's behalf, a further 35% of the amount invested by the employee. Participation at December 31, 1998 was 5,100 employees (1,893 at December 31, 1997). The total number of ESIP shares purchased on behalf of employees, including the Company's contributions, was 122,061 in 1998 and 19,203 in 1997.

B. Stock options

The Company has stock option plans for eligible managers to acquire common shares of the Company upon vesting at a price equal to the market value of the common shares at the date of granting. The options are exercisable during a period not to exceed 10 years. The right to exercise options generally accrues over a period of four years of continuous employment. Options are not generally exercisable during the first 12 months after the date of grant. At December 31, 1998, a total of 5.9 million common shares remained authorized for issuance under these plans.

Options issued by the Company include conventional options, which vest over a period of time, and performance options, which vest upon the attainment of Company targets relating to the operating ratio and unlevered return on investment. The total conventional and performance options outstanding at December 31, 1998 were 2.5 million and 1.0 million, respectively.

Changes in the Company's stock options are as follows:

	Number of options	Weighted-average exercise price
	In millions	
Outstanding at December 31, 1995	1.0	$27.00
Granted	0.6	$37.20
Canceled	(0.1)	$29.32
Outstanding at December 31, 1996	1.5	$31.14
Granted	0.6	$56.59
Canceled	(0.2)	$29.50
Exercised	(0.1)	$31.06
Outstanding at December 31, 1997	1.8	$38.87
Conversion of IC options	1.5	U.S.$45.14
Granted	0.6	$74.70
Canceled	(0.2)	$40.44
Exercised (1)	(0.2)	$38.84
Outstanding at December 31, 1998 (1)	**3.5**	**$58.22**

(1) Includes the IC converted stock options translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

Stock options outstanding as at December 31, 1998 were as follows:

	Options outstanding				Options exercisable	
	Range of exercise prices	Number of options	Weighted-average years to expiration	Weighted-average exercise price	Number of options	Weighted-average exercise price
		In millions			*In millions*	
Options granted in 1995	$27.00	0.5	4	$27.00	0.3	$27.00
Options granted in 1996	$37.04–$47.44	0.4	4	$37.27	0.1	$37.50
Options granted in 1997	$49.70–$77.50	0.5	6	$56.78	–	$58.81
Options granted in 1998 (1)	$12.91–$93.70	2.1	8	$71.02	1.5	$69.43
Balance at December 31, 1998 (1)		**3.5**	6	**$58.22**	**1.9**	**$60.74**

(1) Includes the IC converted stock options translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

C. Stock-based compensation expense

Compensation expense for certain performance-based stock-option awards under these plans is determined by the options' intrinsic value in accordance with APB 25, "Accounting for Stock Issued to Employees," and related interpretations. Compensation expense recognized for stock-based awards was $13 million, $17 million and $14 million in 1998, 1997 and 1996, respectively. Had compensation expense been determined based upon fair values at the date of grant for awards under these plans, consistent with the methods of FAS 123, "Accounting for Stock-Based Compensation," the Company's pro-forma net income and earnings per share would have been as follows:

	1998	1997	1996
Net income *(in millions)*	**$ 270**	$1,051	$ 857
Basic earnings per share	**$2.95**	$12.35	$10.09
Diluted earnings per share	**$2.92**	$12.19	$ 9.98

These pro-forma amounts include compensation costs as calculated using the Black-Scholes option pricing model with the following assumptions:

	1998	1997	1996
Expected option life *(years)*	**7.0**	7.0	7.0
Risk-free interest rate	**5.52%**	6.05%	7.39%
Expected stock price volatility	**30%**	30%	30%
Average dividend per share	**$1.06**	$0.92	$0.80

13 Pensions

The Company has retirement benefit plans under which substantially all employees are entitled to benefits at retirement age, generally based on compensation and length of service and/or contributions. The tables that follow pertain to all such plans. However, the following descriptions relate solely to the Company's main pension plan, the CN Pension Plan. The Company's other pension plans are not significant.

Description of plan

The CN Pension Plan (the Pension Plan) is a contributory defined benefit pension plan that covers substantially all CN employees. It provides for pensions based mainly on years of service and final average pensionable earnings and is generally applicable from the first day of employment. Indexation of pensions is provided after retirement through a gain (loss) sharing mechanism, subject to guaranteed minimum increases. An independent trust company is the Trustee of the Canadian National Railways Pension Trust Funds (CN Pension Trust Funds). As Trustee, the trust company performs certain duties which include holding legal title to the assets of the CN Pension Trust Funds and ensuring that the Company, as Administrator, complies with the provisions of the Pension Plan and the related legislation.

Funding policy

Employee contributions to the Pension Plan are determined by the plan rules. Company contributions are in accordance with the requirements of the Government of Canada legislation, The Pension Benefits Standards Act, 1985, and are determined by actuarial valuations conducted at least on a triennial basis. These valuations are made in accordance with legislative requirements and with the recommendations of the Canadian Institute of Actuaries for the valuation of pension plans.

13 Pensions *(continued)*

Description of fund assets

The assets of the CN Pension Plan are separately accounted for in the CN Pension Trust Funds. These assets consist of cash and short-term investments, bonds, mortgages, Canadian and foreign equities, real estate, and oil and gas assets.

(a) Change in benefit obligation

In millions *Year ended December 31,*	1998	1997
Benefit obligation at beginning of year	$ 9,151	$8,428
Amendments	212	–
Service cost	81	51
Interest cost	629	614
Plan participants' contributions	76	77
Foreign currency changes	7	2
Effect of curtailment	23	–
Actuarial loss	1,006	593
Benefit payments and transfers	(645)	(614)
Benefit obligation at end of year	$10,540	$9,151

(b) Change in plan assets

In millions *Year ended December 31,*	1998	1997
Fair value of plan assets at beginning of year	$ 9,984	$9,279
Actual return on plan assets	1,229	1,172
Employer contributions	77	68
Plan participants' contributions	76	77
Foreign currency changes	7	2
Benefit payments and transfers	(645)	(614)
Fair value of plan assets at end of year	$10,728	$9,984

(c) Funded status

In millions *December 31,*	1998	1997
Excess of fair value of plan assets over benefit obligation at end of year	$ 188	$ 833
Unrecognized net actuarial gain	(372)	(929)
Unrecognized net transition obligation	96	122
Unrecognized prior service cost	193	9
Net amount recognized	$ 105	$ 35

(d) Amount recognized in the Consolidated Balance Sheet

In millions *December 31,*	1998	1997
Prepaid benefit cost	$ 112	$ 42
Accrued benefit cost	(7)	(7)
Additional minimum liability	(5)	–
Intangible asset	3	–
Accumulated other comprehensive income	2	–
Net amount recognized	$ 105	$ 35

(e) Components of net periodic benefit cost

In millions *Year ended December 31,*	1998	1997	1996
Service cost	$ 81	$ 51	$ 45
Interest cost	629	613	611
Expected return on plan assets	(701)	(657)	(642)
Amortization of net transition obligation	21	20	20
Amortization of prior service cost	20	2	1
Recognized net actuarial loss	–	12	9
Net periodic benefit cost	$ 50	$ 41	$ 44

(f) Weighted-average assumptions

December 31,	1998	1997	1996
Discount rate	6.00%	6.50%	7.50%
Rate of compensation increase	4.25%	4.50%	4.50%
Expected return on plan assets for year ending December 31	9.00%	8.25%	8.40%

As at December 31, 1998, one of the Company's pension plans had an accumulated benefit obligation ($114 million) in excess of the fair value of the plan assets ($102 million) which gives rise to additional minimum pension liability. The projected benefit obligation was $119 million at December 31, 1998.

Assuming the change in accounting policy for pension costs had been applied retroactively, the use of the corridor approach would have resulted in a net periodic cost of $29 million for 1997 and $36 million for 1996.

During 1998, the Company recorded a special charge for workforce reductions of $590 million which includes $36 million related to the curtailment of the Pension Plan. The curtailment increased the projected benefit obligation by $23 million and reduced the unrecognized transition obligation and unrecognized prior service cost by $5 million and $8 million, respectively.

14 Special charges and extraordinary item

A. Special charges – Workforce reductions

The Company recorded a charge to operations of $590 million in 1998 and $365 million in 1996 for workforce reduction plans aimed at reducing future operating costs and increasing productivity. The 1998-charge of $590 million includes severance and other payments to be made for approximately 3,000 reductions (1,400 occurred in 1998 with the remainder planned to be completed before the end of 1999). Labor productivity and operating efficiency initiatives span the entire organization with reductions in the administration, transportation, engineering and equipment functions. The majority of payments related to workforce reductions are expected to occur throughout the next six years.

B. Extraordinary item – Loss on extinguishment of long-term debt

The loss on extinguishment of long-term debt in 1996 amounted to $16 million.

15 Interest expense

In millions — Year ended December 31,	1998	1997	1996
Interest on long-term debt	$257	$121	$109
Interest on short-term borrowings	2	2	7
Interest income	(17)	(6)	(3)
Total continuing operations	$242	$117	$113
Cash interest payments for continuing operations	$192	$109	$118

16 Other income

In millions — Year ended December 31,	1998	1997	1996
Gain on disposal of properties	$ 51	$ 37	$ 26
Investment income	20	19	20
Net rental loss	(20)	(10)	(9)
Income (loss) from Canac Inc.	5	(2)	(1)
Gain on sale of interest in joint venture	–	21	–
Other	(13)	(3)	5
	$ 43	$ 62	$ 41

17 Income taxes

The Company's income tax (expense) recovery from continuing operations is as follows:

In millions — Year ended December 31,	1998	1997	1996
Combined basic Canadian federal and provincial tax rate (combined basic tax rate)	44.4%	44.4%	44.4%
Income tax expense from continuing operations based on the combined basic tax rate	$(132)	$(370)	$ (68)
Income tax (expense) recovery resulting from:			
Federal large corporations tax and other cash taxes	(18)	(10)	(11)
Equity in earnings of IC	47	–	–
Gain on disposal of properties	8	4	5
Other	21	11	(5)
Recognition of income tax benefits related to prior years	–	–	773
Income tax (expense) recovery from continuing operations	$ (74)	$(365)	$ 694
Income tax (expense) recovery from continuing operations is represented by:			
Current	$ (18)	$ (10)	$ (11)
Deferred	(56)	(355)	705
	$ (74)	$(365)	$ 694
Income tax recovery (expense) related to discontinued operations	$ –	$ 12	$ (3)
Cash payments for income taxes	$ 18	$ 10	$ 11

Significant components of deferred income tax assets and liabilities are as follows:

In millions — December 31,	1998	1997
Deferred income tax assets		
Loss carryforwards	$222	$165
Workforce reduction provisions	352	178
Accruals and other reserves	76	42
Post-retirement benefits	20	45
	670	430
Deferred income tax liabilities		
Properties	866	536
	866	536
Total net deferred income tax liability	196	106
Net current deferred income tax asset	131	241
Net long-term deferred income tax liability	$327	$347

18 Discontinued operations

Consistent with the Company's plan to focus resources on operating a transportation network, in late 1997, the Company adopted a formal plan to exit its telecommunication business operated by a subsidiary.

In late 1996, the Company sold all the shares of CN France S.A., a wholly-owned subsidiary, to Scribe Gestion S.A. The net proceeds retained by the Company resulted in a gain of $14 million.

A. Income (loss) from discontinued operations

Amounts included in the Consolidated Statement of Income are comprised as follows:

In millions — Year ended December 31,	1998	1997	1996
Net income (loss):			
CN France	$ –	$ –	$ 4
Telecommunication business	–	(6)	(4)
Net loss from discontinued operations	–	(6)	–
Provision for loss on disposal of telecommunication business activities, net of income tax recovery of $8 million	–	(12)	–
Gain on disposal of investment in CN France, net of applicable income taxes of $6 million	–	–	14
	–	(12)	14
Discontinued operations (net of applicable income taxes)	$ –	$(18)	$ 14

18 Discontinued operations *(continued)*

B. Net liabilities of discontinued operations

Amounts included in the Consolidated Balance Sheet are comprised as follows:

In millions December 31,	1998	1997
Current assets	$ 8	$10
Deferred income taxes	6	6
Total assets	14	16
Current liabilities	17	19
Other liabilities and deferred credits	1	1
Total liabilities	18	20
Net liabilities	$ 4	$ 4

C. Net (decrease) increase in cash

Amounts included in the Consolidated Statement of Cash Flows are comprised as follows:

In millions Year ended December 31,	1998	1997	1996
Operating activities	$ –	$(44)	$(22)
Investing activities	–	24	33
Financing activities	–	–	(1)
Cash (used by) provided from discontinued operations	$ –	$(20)	$ 10

19 Segmented information

A. Geographic areas

The majority of the Company's operations and assets are within Canada with the exception of U.S. rail operations.

B. International traffic

In addition to the revenue generated by U.S. rail operations, the Company derives revenue from Canadian rail operations originating or terminating on railroads in the United States. These revenues amounted to approximately $978 million in 1998, $997 million in 1997 and $905 million in 1996.

C. Investment in Illinois Central Corporation

In February 1998, the Company and IC entered into a merger agreement pursuant to which all IC common shares acquired by the Company were placed in a voting trust pending STB approval of the Company's acquisition of control of IC. Until STB approval, the Company will account for its investment in IC using the equity method. Upon receipt of STB approval, all additional information pertaining to IC will be included in the Company's U.S. rail segment.

D. Information on geographic areas

In millions Year ended December 31,	1998	1997	1996
Revenues:			
Canadian rail	$ 3,516	$ 3,742	$ 3,382
U.S. rail	605	580	574
	$ 4,121	$ 4,322	$ 3,956
Operating income:			
Canadian rail	$ 381	$ 846	$ 198
U.S. rail	37	81	25
	$ 418	$ 927	$ 223
Income (loss) from continuing operations:			
Canadian rail	$ 225	$ 417	$ 878
U.S. rail	(106)	52	(30)
Equity in earnings of IC	105	–	–
	$ 224	$ 469	$ 848
Depreciation and amortization:			
Canadian rail *(i)*	$ 304	$ 303	$ 185
U.S. rail	15	14	10
	$ 319	$ 317	$ 195
Capital expenditures: (ii)			
Canadian rail *(iii)*	$ 787	$ 745	$ 463
U.S. rail	84	48	32
	$ 871	$ 793	$ 495

In millions December 31,	1998	1997
Identifiable assets:		
Canadian rail	$ 7,713	$ 7,426
U.S. rail	404	557
Investment in IC	3,821	–
	11,938	7,983
Discontinued operations	14	16
	$11,952	$ 7,999

(i) Includes $3 million (1997: $2 million, 1996: $2 million) depreciation and amortization of properties related to net rental income and Canac Inc.

(ii) Represents additions to properties.

(iii) Includes $17 million (1997: $5 million, 1996: $1 million) additions of properties related to net rental income and Canac Inc. This amount also includes non-cash capital expenditures financed with capital leases and capitalized depreciation.

20 Earnings per share

In 1997, the Company retroactively adopted FAS 128, "Earnings per Share," for computing and presenting earnings per share. As a result, the 1996 earnings per share figures have been restated to conform with FAS 128.

Year ended December 31,	**1998**	1997	1996
Basic earnings per share			
Income from continuing operations	**$2.45**	$ 5.51	$9.99
Discontinued operations	–	(0.21)	0.16
Extraordinary item	–	–	(0.19)
Cumulative effect of change in accounting policy	**0.46**	6.92	–
Net income	**$2.91**	$12.22	$9.96
Diluted earnings per share			
Income from continuing operations	**$2.42**	$ 5.44	$9.88
Discontinued operations	–	(0.21)	0.16
Extraordinary item	–	–	(0.19)
Cumulative effect of change in accounting policy	**0.46**	6.83	–
Net income	**$2.88**	$12.06	$9.85

The following table provides a reconciliation between basic and diluted earnings per share:

In millions, except per share data *Year ended December 31,*	**1998**	1997	1996
Income from continuing operations	**$ 224**	$ 469	$ 848
Weighted-average shares outstanding	**91.5**	85.1	84.9
Effect of dilutive securities and stock options	**0.9**	1.1	1.0
Weighted-average diluted shares outstanding	**92.4**	86.2	85.9
Basic earnings per share	**$2.45**	$5.51	$9.99
Diluted earnings per share	**$2.42**	$5.44	$9.88

Pro-forma amounts assuming retroactive application of new accounting methods for pensions and post-retirement benefits other than pensions and track replacement costs:

In millions, except per share data *Year ended December 31,*	**1998**	1997	1996
Income from continuing operations	**$ 224**	$ 475	$ 376
Basic earnings per share	**$2.45**	$5.58	$4.43
Diluted earnings per share	**$2.42**	$5.51	$4.38
Net income	**$ 224**	$ 457	$ 374
Basic earnings per share	**$2.45**	$5.37	$4.40
Diluted earnings per share	**$2.42**	$5.30	$4.35

21 Major commitments and contingencies

A. Leases

The Company's commitments as at December 31, 1998 under operating and capital leases totaling $1,394 million and $1,143 million, respectively, with annual net minimum payments in each of the five following fiscal years to 2004 and thereafter, are as follows:

Year *In millions*	Operating	Capital
1999	$ 231	$ 106
2000	204	85
2001	209	91
2002	202	35
2003	176	33
2004 and thereafter	372	793
	$1,394	1,143
Less: imputed interest on capital leases at rates ranging from approximately 4¾% to 14¼%		530
Present value of minimum lease payments at current rate included in debt		$ 613

B. Other commitments

As at December 31, 1998, the Company had commitments to acquire locomotives and freight cars at an aggregate cost of $149 million, rail at a cost of $43 million, railroad ties at a cost of $44 million, automotive equipment at a cost of $15 million and intermodal equipment at a cost of $2 million. Further, as at December 31, 1998, the Company had entered into car repair commitments totaling $26 million for the years 1999 to 2002 and into agreements with fuel suppliers to purchase approximately 57% of its anticipated 1999 volume at market prices prevailing on the date of the purchase.

C. Contingencies

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1998 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position.

21 Major commitments and contingencies *(continued)*

D. Environmental matters

The Company's operations are subject to federal, provincial, state, municipal and local regulations under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances, and other materials, decommissioning of underground and aboveground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate ownership, operation or control, and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railroad operations and relating to its past and present ownership, operation or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years, based on known information, for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities. The magnitude of such additional liabilities and the costs of complying with environmental laws and containing or remediating contamination cannot be reasonably estimated due to:

(i) the lack of specific technical information available with respect to many sites;

(ii) the absence of any government authority, third-party orders, or claims with respect to particular sites;

(iii) the potential for new or changed laws and regulations and for development of new remediation technologies and uncertainty regarding the timing of the work with respect to particular sites;

(iv) the ability to recover costs from any third parties with respect to particular sites; and

therefore, the likelihood of any such costs being incurred or whether such costs would be material to the Company cannot be determined at this time. Therefore, there can be no assurance that material liabilities or costs related to environmental matters will not be incurred in the future or that the Company's liquidity will not be adversely impacted by such environmental liabilities or costs. Although the effect on operating results and liquidity cannot be reasonably estimated, management believes, based on current information, that environmental matters will not have a material adverse effect on the Company's financial condition or competitive position. Costs related to any future remediation will be accrued in the year in which they become known.

As at December 31, 1998, the Company had aggregate accruals for environmental costs of $65 million ($76 million as at December 31, 1997). During the year, $11 million was charged to the provision for environmental costs compared to $11 million in 1997 and $11 million in 1996. In addition, related environmental capital expenditures were $13 million in 1998, $13 million in 1997 and $13 million in 1996. The Company also expects to incur capital expenditures relating to environmental matters of approximately $15 million in 1999, $7 million in 2000 and $6 million in 2001. The Company has not included any reduction in costs for anticipated recovery from insurance.

E. Uncertainty due to Year 2000 issue

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the Year 2000 as 1900 or some other date, resulting in errors when information using Year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the Company's ability to conduct normal business operations. There can be no assurance that all aspects of the Year 2000 issue affecting the Company, including those related to the efforts of customers, suppliers or other third parties, will be fully resolved.

22 Financial instruments

A. Risk management

The Company has limited involvement with derivative financial instruments in the management of its fuel, interest rate and foreign currency exposures, and does not use them for trading purposes.

(i) Credit risk

The Company is exposed to credit risk in the event of non-performance by counterparties to its derivative financial instruments but does not expect such non-performance as counterparties are of high credit quality. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. However, the credit standing of counterparties is regularly monitored. The total risk associated with the Company's counterparties was immaterial at December 31, 1998. The Company believes there are no significant concentrations of credit risk.

(ii) Interest rates

In anticipation of the issuance of the U.S.$925 million of long-term debt with respect to the IC acquisition (see Note 3), the Company hedged a portion of its exposure to interest rate risk by means of forward contracts and options. The hedging cost amounting to U.S.$13 million (Cdn$19 million) is being amortized over the term of the respective debt issues.

(iii) Foreign currency

Although the Company conducts a majority of its business and receives revenues primarily in Canadian dollars, a significant portion of its business is conducted and revenues are denominated in U.S. dollars. Thus, the Company's results are affected by fluctuations in the exchange rate between these currencies. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby affect the Company's revenues.

The Company has entered into a forward exchange contract (currency swap) with respect to its 15-year Swiss franc bonds. This forward exchange contract acts as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred any significant net gains or losses in respect of this transaction. Losses due to non-performance by the counterparty to its foreign currency swap are not anticipated.

Effective April 1, 1998, the Company designated U.S.$1.8 billion of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Effective June 4, 1998, and corresponding with the completion of the second step of the IC acquisition, the Company increased that designated amount to include all of its U.S. dollar denominated debt. The result is that unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's U.S. dollar denominated debt are included in Accumulated other comprehensive income, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC, which forms part of Shareholders' equity.

(iv) Fuel

The Company has a hedging program in place to mitigate the effects of fuel price changes on its operating margins and overall profitability. The Company has entered into various swaps and collar agreements to mitigate the risk of fuel price volatility. The Company also monitors its hedging positions and the credit ratings of its counterparties and does not anticipate losses due to counterparty non-performance. At December 31, 1998, the Company has hedged approximately 30% of the estimated 1999 fuel consumption. Unrecognized losses from the Company's fuel hedging activities amounted to $8 million at December 31, 1998.

B. Fair value of financial instruments

Generally accepted accounting principles define the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company uses the following methods and assumptions to estimate the fair value of each class of financial instruments for which the carrying amounts are included in the Consolidated Balance Sheet under the following indicated captions:

(i) Cash and cash equivalents, Accounts receivable, Accounts payable and accrued charges, and Other current liabilities:

The carrying amounts approximate fair value because of the short maturity of these instruments.

(ii) Other assets and deferred charges:

Investments: The Company has various debt and equity investments for which the carrying value approximates the fair value.

(iii) Long-term debt:

The fair value of the Company's long-term debt is estimated based on the quoted market prices for the same or similar debt instruments.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments as at December 31, 1998 and 1997 for which the carrying values are not disclosed on the Consolidated Balance Sheet or for which the carrying amounts are different from the fair values:

In millions	***December 31, 1998***		*December 31, 1997*	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial assets				
Investments	**$ 50**	**$ 50**	$ 50	$ 50
Financial liabilities				
Long-term debt	**$3,995**	**$4,093**	$1,628	$1,682

23 Other comprehensive income

(a) Components of Other comprehensive income and the related tax effects for the year ended December 31, 1998 are as follows:

In millions	Before tax amount	Income tax (expense) recovery	Net of tax amount
Unrealized foreign exchange loss on translation of U.S. dollar denominated long-term debt	$(246)	$ 102	$(144)
Unrealized foreign exchange gain on translation of IC net investment	259	(108)	151
Minimum pension liability adjustment	(2)	1	(1)
Other comprehensive income	**$ 11**	**$ (5)**	**$ 6**

(b) Changes in the balances of each classification within Other comprehensive income are as follows:

In millions	Foreign exchange U.S.$ debt	Foreign exchange IC investment	Minimum pension liability adjustment	Accumulated other comprehensive income
Beginning balance	$ –	$ –	$ –	$ –
Current period change	(144)	151	(1)	6
Ending balance	**$ (144)**	**$ 151**	**$ (1)**	**$ 6**

24 Comparative figures

Certain figures, previously reported for 1997 and 1996, have been reclassified to conform with the basis of presentation adopted in the current year.

Contents

Canadian National Railway Company

The CN Pension Plan and the CN 1935 Pension Plan

Management's discussion and analysis relates to the financial condition and results of operations of Canadian National Railway Company (CN) together with its wholly-owned subsidiaries, including Grand Trunk Corporation, which holds the investment in Illinois Central Corporation (IC). As used herein, the word "Company" means, as the context requires, CN and its subsidiaries and IC. CN's common shares are listed on the Toronto, New York and Montreal stock exchanges. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars and determined on the basis of Canadian generally accepted accounting principles (Canadian GAAP).

Financial results

1998 compared to 1997

The Company recorded consolidated net income of $109 million ($1.19 per share) for the year ended December 31, 1998 compared to consolidated net income of $403 million ($4.74 per share) in 1997.

The 1998 and 1997 results of operations included several items of a non-recurring nature, namely the 1998-special charge of $590 million ($345 million after tax) and the 1997 gain on sale of the Company's interest in a joint venture of $21 million ($12 million after tax).

Excluding the non-recurring items, the Company recorded consolidated net income of $454 million ($4.96 per share) for 1998 compared to $391 million ($4.59 per share) in 1997.

Revenues for 1998 totaled $4,144 million, a decrease of $208 million, or 5%, from the comparable 1997 level. The decline was mainly attributable to grain and grain products and automotive. The Company undertook or accelerated several initiatives to allay the impact of the 1998 decline in traffic volumes which led to overall cost reductions of $238 million, or 7%, from 1997. The initiatives included a focus on improving asset utilization, fuel consumption and yard operations.

Operating income was $247 million for 1998 compared to $807 million in 1997, a decrease of $560 million. Excluding the 1998-special charge, operating income was $837 million for 1998, an increase of $30 million, or 4%, over 1997. The operating ratio, excluding the 1998-special charge, improved year-over-year from 81.5% to 79.8%.

The consolidated net income for 1998 includes several items related to the acquisition of IC, including interest expense of $117 million ($68 million after tax) as well as equity in earnings of IC of $86 million. The total impact of the interest and equity in earnings of IC had the effect of increasing the consolidated net income by $18 million for 1998.

Revenues

Revenues for the year ended December 31, 1998 totaled $4,144 million. The decrease from 1997 was mainly attributable to grain and grain products and automotive. Revenue ton miles declined by a corresponding 6% when compared to 1997. Revenue per revenue ton mile for the year increased 1% to 3.60 cents in 1998.

Year ended December 31,	1998	1997	1998	1997	1998	1997
	Revenues		Revenue ton miles		Freight revenue per revenue ton mile	
	In millions				*In cents*	
Industrial products	$ 874	$ 863	23,095	22,870	3.78	3.77
Forest products	851	824	22,977	22,784	3.70	3.62
Grain and grain products	554	692	18,937	24,676	2.93	2.80
Coal, sulfur, and fertilizers	644	665	25,830	26,568	2.49	2.50
Intermodal	762	776	19,913	19,541	3.83	3.97
Automotive	385	435	2,177	3,095	17.68	14.05
Other items (1)	74	97	–	–	–	–
Total	$4,144	$4,352	112,929	119,534	3.60	3.56

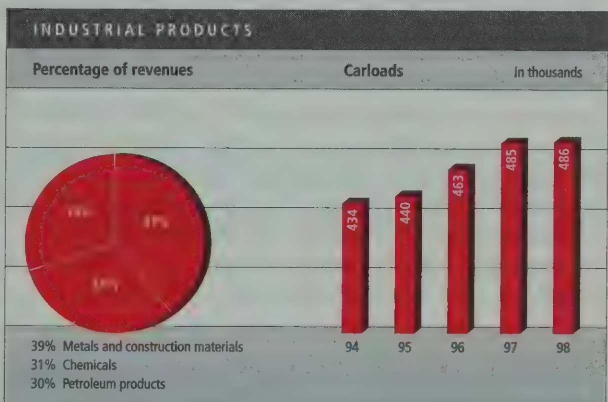
(1) Principally non-freight revenues derived from third parties.

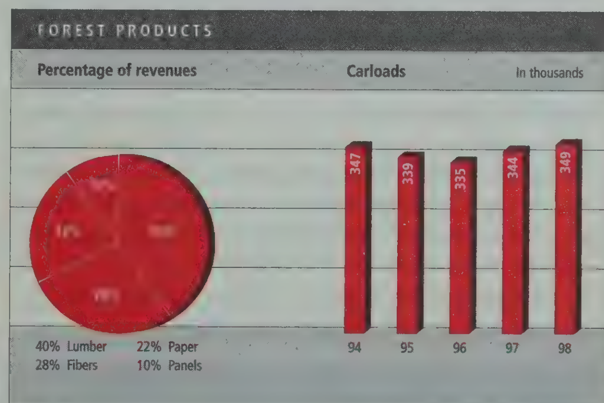
Industrial products – Revenues increased by 1% and volumes increased by 1%

Revenues increased by $11 million over 1997. The 1998 growth was largely attributable to strength in petroleum products traffic, particularly plastics and fuel oils, and in metals shipments generated by pipeline projects in western Canada, as well as an improvement in aluminum traffic as a result of strong market conditions in the United States. These gains were partially offset by softness in the chemicals markets and the impact of the Company's network rationalization program. Revenue per revenue ton mile remained relatively flat as compared to 1997.

Forest products – Revenues increased by 3% and volumes increased by 1%

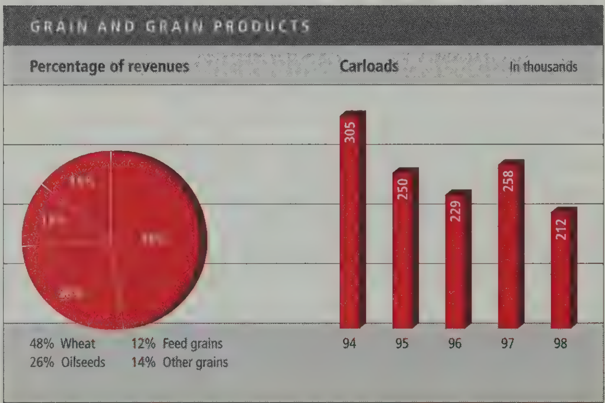
Revenues increased by $27 million over 1997. The 1998 growth was driven by increased lumber and panels traffic due to continued strength in U.S. housing activity and market share gains. Partially offsetting these increases were a six-month strike at a major North American paper producer and the impact of the Company's network rationalization program. The increase in revenue per revenue ton mile of 2% was mainly due to a shift in traffic patterns and the weakness in the Canadian dollar.





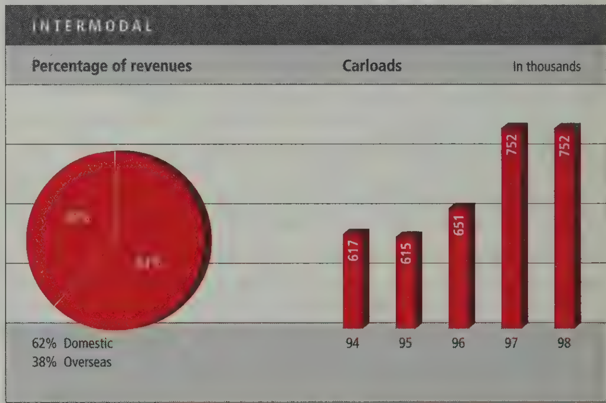
Grain and grain products – Revenues decreased by 20% and volumes decreased by 23%

Revenues decreased by $138 million from 1997. The 1998 decline reflected a very strong comparative year in 1997 due to the 1996/1997 bumper crop and softness in export markets for wheat and feed grains. Canola oil and seed shipments improved throughout the year, consistent with overall market strength. The revenue per revenue ton mile improvement of 5% was mainly due to the regulated rate increase of 2% on export grain effective August 1997, as well as a decline in longer haul export traffic.



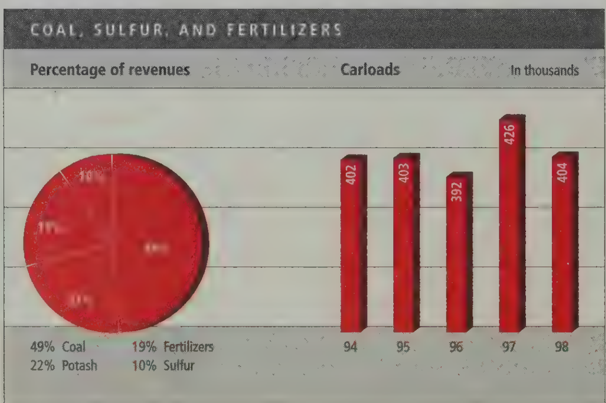
Intermodal – Revenues decreased by 2% and volumes increased by 2%

Revenues decreased by $14 million from 1997. The 1998 decline in the domestic segment was due to weaker shipments to western Canada, as well as the adverse effect of customers' concerns regarding a potential strike at the Company during labor negotiations, which were concluded in the latter part of the third quarter. Partially offsetting domestic weakness was strength in overseas traffic, particularly imports through the west coast. The decrease in revenue per revenue ton mile of 4% was largely due to a shift to longer haul traffic, particularly in the overseas market.



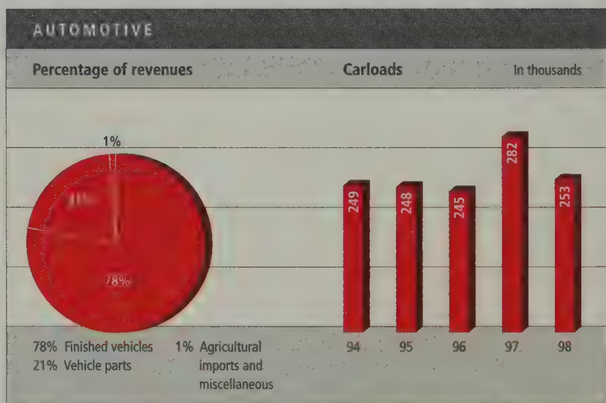
Coal, sulfur, and fertilizers – Revenues decreased by 3% and volumes decreased by 3%

Revenues decreased by $21 million from 1997. The 1998 decrease was mainly attributable to lower coal export traffic as a result of weak international coal markets, particularly from reductions in Asian steel production. Continued excess supply in the international sulfur market also contributed to the decline. Lower overall Canadian potash exports led to a decline in potash revenues partially offset by new sourcing from western Canada following a mine closure in eastern Canada. Revenue per revenue ton mile remained relatively flat as compared to 1997.



Automotive – Revenues decreased by 11% and volumes decreased by 30%

Revenues decreased by $50 million from 1997. The 1998 decline was due primarily to the impact of a June and July strike at a major U.S. automobile manufacturer, reduced production at a major Company-served auto plant due to retooling, and a corporate decision to shed unprofitable business. The increase in revenue per revenue ton mile of 26% was driven by changes in customer distribution patterns, a corporate decision to shed unprofitable business, and weakness in the Canadian dollar.



Operating expenses

Total operating expenses amounted to $3,897 million in 1998 as compared to $3,545 million in 1997. Operating expenses, excluding the special charge, amounted to $3,307 million in 1998, a decrease of $238 million, or 7%.

Dollars in millions — *Year ended December 31,*	1998		1997	
	Amount	**% of revenue**	Amount	% of revenue
Labor and fringe benefits	**$1,456**	**35.1%**	$1,459	33.5%
Material	**270**	**6.5%**	316	7.3%
Fuel	**249**	**6.0%**	335	7.7%
Depreciation and amortization	**210**	**5.1%**	200	4.6%
Operating taxes	**172**	**4.1%**	186	4.3%
Equipment rental	**207**	**5.0%**	219	5.0%
Net car hire	**83**	**2.0%**	116	2.7%
Purchased services	**338**	**8.2%**	363	8.3%
Casualty and insurance	**66**	**1.6%**	75	1.8%
Other	**256**	**6.2%**	276	6.3%
	3,307	**79.8%**	3,545	81.5%
Special charge	**590**		–	
Total operating expenses	**$3,897**		$3,545	

Labor and fringe benefits: Labor and fringe benefit expenses decreased by $3 million during 1998. Lower volumes and the impact of the Company's downsizing efforts, as the average number of employees declined from 22,800 in 1997 to 21,514 in 1998, were offset by wage increases and higher pension expense, mainly attributable to benefits related to the new collective agreements, as well as an adjustment to workers' compensation expense following a comprehensive study of the accounting for these costs.

Material: Costs of material consumed during 1998 were $46 million, or 15%, lower than in 1997, mainly as a result of the Company's network rationalization initiatives and the temporary closure of certain repair facilities.

Fuel: The decline in the average price of fuel of 12% (including the effects of the Company's fuel hedging program) as well as reduced volume levels and a 10% improvement in fuel efficiency largely produced a decrease in fuel expense for 1998 of $86 million, or 26%, over 1997.

Depreciation and amortization: Depreciation and amortization expense increased by $10 million in 1998. The increase is due to the 1998 capital additions, as well as the acquisition of new locomotives in the latter part of 1997.

Operating taxes: Operating taxes decreased by $14 million, or 8%, during 1998, mainly as a result of a decrease in diesel fuel taxes and municipal property taxes.

Equipment rental: These expenses decreased by $12 million, or 5%, in 1998, largely as a result of an increase in locomotive short-term lease income.

Net car hire: Car hire costs decreased by $33 million, or 28%, in 1998, due mainly to decreased car hire expenses on covered hopper grain cars, decreased volumes and improved asset utilization.

Purchased services: Costs of purchased services decreased by $25 million, or 7%, in 1998, largely as a result of lower professional fees, cost reductions on a locomotive maintenance contract, lower vehicle leasing costs and deadheading costs. This was partially offset by decreased cost recoveries related to joint facility projects and increased costs related to detouring traffic as a result of the 1998 ice storm in eastern Canada.

Casualty and insurance: These expenses decreased by $9 million, or 12%, during 1998, mainly as a result of an improved safety record, lower costs of train accidents and legal claims related to injuries to persons. The decrease was partially mitigated by a 1997 recovery from a third party.

Other: These expenses decreased by $20 million, or 7%, in 1998 compared to 1997, mainly due to the capitalization of certain costs related to information technology system development projects, decreased utility costs, higher recoveries from third parties and the write-off of certain accounts receivable in 1997.

Special charge: The Company recorded a $590-million pre-tax charge ($345 million after tax) to operations in the third quarter of 1998 for workforce reduction plans aimed at reducing future operating costs and increasing productivity. The charge includes severance and other payments to be made for approximately 3,000 reductions, 1,400 of which occurred in 1998, with the remainder planned to be completed before the end of 1999. Labor productivity and operating efficiency initiatives span the entire organization with reductions in the administration, transportation, engineering and equipment functions.

Other

Interest expense: Interest expense for the year ended December 31, 1998 was $244 million compared to $118 million in 1997, an increase of $126 million. The increase reflects the impact of the financing related to the acquisition of IC, as well as the financing related to the locomotive upgrade program and other capital leases, which was partially offset by repurchases of some of the Company's outstanding long-term debt in the latter part of 1997.

Equity in earnings of Illinois Central Corporation: The Company applies the equity method of accounting for its investment in IC. Accordingly, equity in the earnings of IC of $86 million was recorded in 1998.

Other income: Other income for the year ended December 31, 1998 was $35 million, a decrease of $18 million from 1997. The decrease was mainly due to the second-quarter 1997 gain on sale of the Company's interest in a joint venture of $21 million.

Foreign exchange (loss) gain: Effective April 1, 1998, the Company designated U.S.$1.8 billion of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Effective June 4, 1998, and corresponding with the completion of the second step of the IC acquisition, the Company increased that designated amount to include all of its U.S. dollar denominated debt. The result is that unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's U.S. dollar denominated debt, are included in Currency translation, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC, which forms part of Shareholders' equity.

Prior to April 1, 1998, and in comparative periods, the Company had designated certain future U.S. dollar revenue streams as a hedge against the repayment of most of its long-term debt denominated in U.S. dollars and thus deferred reflecting the related unrealized foreign currency translation gains and losses in net income until the earlier of the debt repayment or such time as the hedge ceases to be effective.

Income tax expense from continuing operations: Income tax expense for the year ended December 31, 1998 was $6 million compared to $325 million for the year ended December 31, 1997. The effective income tax rate for 1998 was affected by the Company's equity in earnings of IC. Excluding the equity in earnings of IC and the special charge, the effective income tax rate was 40.6% in 1998. The effective tax rate in 1997 was 43.6%.

1997 compared to 1996

The Company recorded a consolidated net income of $403 million ($4.74 per share) for the year ended December 31, 1997 compared to consolidated net income of $850 million ($10.01 per share) in 1996.

Operating income was $807 million for the year ended December 31, 1997 compared to $610 million in 1996, excluding special charges of $381 million, an increase of $197 million, or 32%. There was a $357 million, or 9%, increase in revenues and a $160 million, or 5%, increase in operating expenses, excluding 1996-special charges. The improved financial performance was largely the result of the Company's focus on profitable revenue growth, improved utilization of assets and cost containment. The operating ratio, excluding 1996-special charges, improved from 84.7% in 1996 to 81.5% in 1997, a 3.2-point betterment.

Revenues

Revenues for the year ended December 31, 1997 totaled $4,352 million, an increase of $357 million, or 9%, from the comparable 1996 level. The increase was attributable to all business units, with grain and grain products at 23%, intermodal at 15% and automotive at 12% leading the way. Revenue ton miles increased by a corresponding 11%.

Year ended December 31,	1997	1996	1997	1996	1997	1996
	Revenues		Revenue ton miles		Freight revenue per revenue ton mile	
	In millions				*In cents*	
Industrial products	$ 863	$ 827	22,870	21,698	3.77	3.81
Forest products	824	787	22,784	21,297	3.62	3.70
Grain and grain products	692	564	24,676	20,755	2.80	2.72
Coal, sulfur, and fertilizers	665	642	26,568	24,583	2.50	2.61
Intermodal	776	677	19,541	16,507	3.97	4.10
Automotive	435	389	3,095	2,630	14.05	14.79
Other items(1)	97	109	–	–	–	–
Total	$4,352	$3,995	119,534	107,470	3.56	3.62

(1) Principally non-freight revenues derived from third parties.

Industrial products – Revenues increased by 4% and volumes increased by 5%

The 1997 growth was mainly due to volume increases in the metals and petroleum products segments. Growth in the metals segment reflects market share gains, strong U.S. market demand for aluminum, and increased pipe movements to western Canada for pipeline construction and municipal development. Strong plastics demand contributed to growth in the petroleum segment. Moderate gains were made in the industrial chemical and petrochemical segments. The decline in yield of 1% resulted from traffic mix changes and the effect of the Ultratrain operation.

Forest products – Revenues increased by 5% and volumes increased by 7%

The improvement was due to increases in all forest products segments. Lumber traffic grew significantly due to a stronger U.S. housing market and successful market share gains. Growth in panels reflected the impact of various new oriented strand board mills which began production in 1996/1997. Improved market conditions and market share gains in newsprint relative to trucking contributed to the strength in the pulp and paper segment. The reduction in revenue per revenue ton mile resulted from increases in longer haul traffic.

Grain and grain products – Revenues increased by 23% and volumes increased by 19%

The improvement is due to the 1996/1997 bumper grain crop compared to the previous year, continued strength in third and fourth-quarter grain sales, and the regulated rate increases of 7.1% and 2% effective August 1996 and 1997, respectively. Revenue per revenue ton mile increased by 3%, primarily due to the rate increases, although these gains were partially offset by increases in longer haul traffic and increased haulage fees as a result of the Company's network rationalization program.

Coal, sulfur, and fertilizers – Revenues increased by 4% and volumes increased by 8%

The increase reflects growth in the potash, coal and fertilizers segments. Growth in potash revenues was primarily a result of strong demand conditions both in U.S. and offshore markets. Increases in the coal segment's revenues reflect significant gains in domestic coal movements and limited growth in coal export traffic, as well as new spot petroleum coke export moves from northern Alberta. The decline in yield of 4% was driven by changes in traffic mix in potash and coal.

Intermodal – Revenues increased by 15% and volumes increased by 18%

The increase reflects an improvement in the Company's market position as well as a strong economy generating healthy growth in domestic and, in particular, overseas market segments. The Company was able to capitalize on this growth partly as a result of on-time performance and service reliability improvements. Contributing to the yield decrease of 3% was the shift to longer haul traffic, particularly in overseas markets, and increased cartage charges.

Automotive – Revenues increased by 12% and volumes increased by 18%

The strength in the automotive business unit was due, in part, to double-digit growth in Canadian motor vehicle sales and moderate gains in U.S. sales. New contracts were signed for finished vehicles destined for the United States and parts traffic inbound to Ontario. The drop in revenue per revenue ton mile of 5% is attributable to a change in traffic mix.

Operating expenses

Total operating expenses amounted to $3,545 million in 1997 as compared to $3,766 million in 1996, including special charges of $381 million. Excluding 1996-special charges, operating expenses increased by $160 million, or 5%, from 1996 while revenue ton miles increased by 11%.

Dollars in millions *Year ended December 31,*	1997		1996	
	Amount	% of revenue	Amount	% of revenue
Labor and fringe benefits	$1,459	33.5%	$1,405	35.2%
Material	316	7.3%	297	7.4%
Fuel	335	7.7%	314	7.9%
Depreciation and amortization	200	4.6%	194	4.8%
Operating taxes	186	4.3%	171	4.3%
Equipment rental	219	5.0%	216	5.4%
Net car hire	116	2.7%	108	2.7%
Purchased services	363	8.3%	348	8.7%
Casualty and insurance	75	1.8%	61	1.5%
Other	276	6.3%	271	6.8%
	3,545	81.5%	3,385	84.7%
Special charges	–		381	
Total operating expenses	$3,545		$3,766	

Labor and fringe benefits: In spite of major volume increases in 1997 and severe winter weather conditions in the first quarter of the same year, these costs increased by only $54 million, or 4%. This was largely due to the Company's downsizing initiatives, as average employment declined by 5%. Labor productivity, as measured by revenue ton miles per average number of employees, improved by 17% to 5.2 million.

Material: Costs of material consumed during 1997 were $19 million, or 6%, higher than in 1996 due to severe winter conditions in early 1997 and to costs incurred under the winter readiness program in the latter part of the year. These costs were partially mitigated by the Company's continued aggressive sourcing initiatives and efficiencies arising from shop consolidation.

Fuel: The combined effect of price and traffic volume increases more than offset fuel efficiency savings, leaving a net increase in fuel costs of $21 million, or 7%, compared to 1996.

Depreciation and amortization: Acquisition of high-productivity locomotives in late 1996 and in 1997, under the locomotive upgrade program, was the main factor behind the increase of $6 million, or 3%.

Operating taxes: Increased provincial sales taxes, due to a one-time recovery in the third quarter of 1996, as well as increases in municipal and fuel taxes, accounted for the $15 million, or 9%, increase in operating taxes in 1997.

Equipment rental: Such costs increased by $3 million, or 1%, compared with 1996 due mainly to additional short-term leases required as a result of increased volumes offset by the acquisition of cars previously under operating leases.

Net car hire: Car hire costs increased by $8 million, or 7%, from 1996. The increase was due primarily to additional per diem car mileage payments as a result of increased traffic volumes, mainly in intermodal.

Purchased services: Costs of purchased services increased by $15 million, or 4%, from the 1996 level, due mainly to increased expenditures for professional services and contracted repairs.

Casualty and insurance: Costs increased by $14 million, or 23%, due mainly to increased provisions for legal claims related to injuries to persons and a 1996 $12-million recovery of insurance premiums associated with the liquidation of the Company's interest in an industry insurance association. This increase was partially mitigated by a decrease in the costs related to train accidents.

Other

Interest expense: Interest expense was $118 million in 1997 compared to $114 million in 1996, an increase of $4 million, or 4%. This increase reflects the impact of the financing related to the locomotive upgrade program offset by the repurchase of some of the Company's outstanding long-term debt.

Other income: Other income for the year ended December 31, 1997 was $53 million compared to $24 million in 1996. The increase was due mainly to the second-quarter 1997 $21-million gain realized on the sale of the Company's joint-venture interest in Halterm Limited and other property sales.

Income tax (expense) recovery from continuing operations: Income tax expense was $325 million in 1997 compared to a recovery of $694 million the preceding year. In the fourth quarter of 1997, the Company adopted new accounting pronouncements from the Canadian Institute of Chartered Accountants related to the accounting for income taxes. These recommendations required retroactive application and restatement of comparative figures. The effect of this change in accounting for income taxes was to record a recovery of future income taxes in 1996 in the amount of $708 million, $3 million of which was related to income (loss) from discontinued operations.

Discontinued operations: Consistent with the Company's plans to focus resources on operating a transportation network, in late 1997, the Company adopted a formal plan to exit its telecommunication business operated by a subsidiary. The loss from discontinued operations (net of applicable income taxes) which includes the current year loss, as well as a provision for future losses from the discontinued operations, amounted to $18 million for 1997. Discontinued operations (net of applicable income taxes) provided income of $14 million in 1996 due primarily to the gain on sale of CN France S.A.

Liquidity and capital resources

Operating activities: Cash provided from continuing operations was $953 million for the year ended December 31, 1998 compared to $678 million for 1997. Cash from continuing operations includes proceeds of $219 million received as a result of the Company's sale of accounts receivable. Income from continuing operations, excluding non-cash items, generated cash of $822 million in 1998, down from $913 million in 1997. A significant portion of the cash generated in 1998 was consumed by payments with respect to workforce reductions of $187 million. As a result of these payments, as well as the 1998 workforce reduction pre-tax special charge of $590 million, which includes $36 million related to a pension curtailment, the workforce reduction accruals have been increased to $825 million as at December 31, 1998. Cash payments with respect to workforce reductions are expected to be approximately $235 million in 1999.

Cash tax payments were $18 million for the year ended December 31, 1998, consisting primarily of Canadian Federal Large Corporations Tax. As at December 31, 1998, the Company had net loss carryforwards and other temporary differences for Canadian federal tax purposes such that it does not expect to make any significant cash payments for Canadian federal income taxes prior to 2000.

Investing activities: Cash used in investing activities in 1998 amounted to $3,012 million, net of proceeds from disposals of $90 million. Investing activities include $2,608 million related to the first-step acquisition of 75% of the outstanding shares of IC capital stock in March 1998. Capital expenditures, excluding items financed under capital leases, amounted to $494 million in the year ended December 31, 1998, an increase of 26% over 1997. Capital expenditures included roadway renewal, rolling stock and other capacity and productivity improvements. The Company anticipates that capital expenditures for 1999 will be approximately $450 million, excluding capital expenditures of IC and capital expenditures related to the integration of CN and IC. This will include funds required for ongoing renewal of the basic plant and other acquisitions and investments required to improve the Company's operating efficiency and customer service.

As at December 31, 1998, the Company had commitments to acquire locomotives and freight cars at a cost of $149 million, rail at a cost of $43 million, railroad ties at a cost of $44 million, automotive equipment at a cost of $15 million and intermodal equipment at a cost of $2 million.

Dividends: The Company paid four quarterly dividends to its shareholders at the rate of $0.265 per share per quarter and in the overall amount of $99 million during 1998.

Financing activities: Financing activities provided cash of $2,056 million for the year ended December 31, 1998. Issuance of long-term debt was used for the acquisition of IC common shares. The initial financing included a U.S.$800 million one-year term loan facility and a U.S.$800 million draw-down on a five-year revolving credit facility. In addition, capital lease financing was used for the acquisition of equipment, including new locomotives under the locomotive upgrade program. In June 1998, the Company initiated a commercial paper program. The Company has since fully repaid the one-year term loan facility and reduced its draw-down on the five-year revolving credit facility with proceeds from the issuance of U.S.$925 million of long-term debt and from the issuance of additional commercial paper. The commercial paper program enables the Company to issue commercial paper up to a maximum aggregate principal amount of $600 million, or the U.S. dollar equivalent, and is supported by the revolving credit facility. As at December 31, 1998, the Company had $532 million (U.S.$347 million) of commercial paper outstanding.

Acquisition of Illinois Central Corporation

If approved by the United States Surface Transportation Board (STB), the acquisition of IC will put the Company in a strong position to take advantage of growing traffic flows in key NAFTA markets by combining its east-west, coast-to-coast Canadian market strength with IC's highly efficient north-south midwest corridor from Chicago to the Gulf of Mexico.

Close of tender offer

On March 14, 1998, pursuant to a first-step cash tender offer, Blackhawk Merger Sub, Inc., a wholly-owned subsidiary of Grand Trunk Corporation, acquired 46.05 million shares of IC common stock, representing 75% of the outstanding IC common stock, for $2,549 million (U.S.$1,796 million), or U.S.$39 per IC share.

Second-step merger

On June 4, 1998, the Company and IC consummated the second-step merger by exchanging the remaining 25% of the outstanding IC common shares at an exchange ratio of 0.633 shares of the Company's common stock per IC share. As a result of the second-step merger, the remaining 25% of IC shares were exchanged for 10.1 million shares of the Company's common stock. In addition, the outstanding IC stock options were exchanged for stock options of the Company.

STB approval

On July 15, 1998, CN and IC filed a formal application with the STB seeking regulatory approval of CN's acquisition of control of IC and the integration of the companies' rail operations.

The IC shares acquired by CN pursuant to the cash tender offer and second-step merger have been placed in a voting trust pending approval of the transaction by the STB. As a result, the Company will not be able to exercise control over IC until the STB approves the Company's acquisition of control of IC. The STB could impose conditions or restrictions as it relates to the Company's acquisition of control of IC. If the STB does not approve the Company's acquisition of control of IC or if the Company deems any conditions imposed by the STB unacceptable, the Company would be obligated to sell all IC common shares held in the voting trust. Such a disposition could materially adversely affect the Company's financial condition and results of operations.

Accounting treatment

The acquisition of IC is accounted for as a purchase. Pending STB approval, the Company accounts for its investment in IC using the equity method. Upon receipt of STB approval, the financial statements of IC will be consolidated with those of the Company. The purchase price allocation will only be finalized after the STB renders its decision.

Acquisition financing

The acquisition of 75% of the outstanding common stock of IC for U.S.$1,796 million was initially financed by a U.S.$800 million one-year term loan facility (Term Facility), a U.S.$800 million draw-down on a five-year revolving credit facility (Revolving Facility), and by cash on hand.

The Term Facility was repaid and the Revolving Facility was reduced with the proceeds from the issuance of U.S.$925 million of long-term debt and the issuance of commercial paper. An amount of U.S.$220 million (Cdn$337 million) remains outstanding under the Revolving Facility as at December 31, 1998. Consequently, the acquisition financing is reflected within long-term debt.

Pro-forma impact of Illinois Central Corporation acquisition

If the Company had acquired its investment in IC on January 1, 1997, based on the historical amounts reported by IC, net of the amortization of the difference between the Company's cost to acquire IC and the underlying historical equity in net assets of IC (based on preliminary estimates of the fair value of IC's properties and equipment and estimates of their remaining useful lives, as well as estimates of the fair value of other IC assets and liabilities), income from continuing operations would have been $132 million ($1.38 per share) for the year ended December 31, 1998 (excluding special charges recorded by IC related to the merger) compared to $450 million ($4.72 per share) for 1997. Income from continuing operations would have included equity in earnings of IC of $128 million for the year ended December 31, 1998 (excluding special charges recorded by IC related to the merger), compared to $119 million for 1997. Income from continuing operations would also have included after-tax interest expense related to the acquisition of $87 million for the year ended December 31, 1998 compared to $90 million for 1997. The pro-forma figures do not reflect synergies, and accordingly, do not account for any potential increases in operating income, any estimated cost savings, facilities consolidation or adjustments to conform accounting practices.

Strategic alliance with Kansas City Southern Railway

On April 15, 1998, CN, IC and the Kansas City Southern Railway Company (KCSR) entered into a 15-year alliance that offers shippers new competitive options in a rail freight transportation network linking key north-south continental freight markets.

A marketing agreement among CN, IC and KCSR links service points in Canada with the major U.S. Midwest markets of Detroit, Chicago, Kansas City and St. Louis, along with the key southern markets of Memphis, Dallas and Houston. Under the marketing agreement, the parties coordinate sales, marketing and operations in a large number of markets and interline traffic at key gateways.

CN and KCSR also signed a separate access agreement regarding certain haulage and trackage rights under which CN and KCSR contemplate investments in automotive, intermodal and transload facilities to capitalize on the growth potential represented by the marketing agreement. The access agreement is contingent upon STB approval of CN's acquisition of control of IC.

The access agreement would give KCSR access to three chemical plants at Geismar, Louisiana, now served by IC, with associated overhead haulage rights from Geismar to Baton Rouge and, for traffic moving to or from certain eastern centers, from Baton Rouge to Jackson. KCSR access to the three Geismar plants is expected to take effect in the fall of 2000.

Under the terms of these agreements, neither CN nor KCSR will acquire equity interests or other financial holdings in the other.

Long-term agreement with Wisconsin Central

On June 15, 1998, the Company announced that CN carload and bulk commodity trains would use the Wisconsin Central route from Superior, Wisconsin to Chicago, Illinois. The agreement is for not less than 20 years and is renewable. It enables CN to use its existing capacity to increase traffic moving between western Canada and the United States. The agreement builds on an already close and mutually beneficial relationship that CN has established with Wisconsin Central.

Business risks

Certain information included in this report may be "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995. Such forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors which may cause the outlook, the actual results or performance of the Company or the rail industry to be materially different from any future results or performance implied by such statements. Such factors include the factors set forth below as well as other risks detailed from time to time in reports filed by the Company with securities regulators in Canada and the United States.

Competition

The Company faces competition from a variety of carriers, including Canadian Pacific Limited, which operates the other major rail system in Canada serving most of the same industrial and population centers as the Company, long distance trucking companies and, in certain markets, major U.S. railroads. Competition is generally based on the quality and reliability of service provided, price and the carrier's equipment. Competition is particularly intense in eastern Canada, where an extensive highway network and population centers located relatively close to one another have encouraged significant competition from trucking companies and rail network over-capacity. In addition, much of the freight carried by the Company consists of commodity goods that are available from other sources in competitive markets. Factors affecting the competitive position of suppliers of these commodities, including exchange rates, could materially affect the demand for goods supplied by the sources served by the Company and, therefore, the Company's volumes, revenues and profit margins.

IC faces significant competition for freight traffic from trucks, river barges, pipeline carriers and other railroads. Competition is generally based on the rates charged and the quality and reliability of the service provided. To a greater degree than other rail carriers, IC's principal railroad subsidiary is vulnerable to barge competition because its main routes are parallel to the Mississippi River system. The use of barges for some commodities, particularly coal and grain, often represents a lower cost mode of transportation. Barge competition and barge rates are affected by navigational interruptions from ice, floods and droughts which can cause widely fluctuating barge rates. The ability of IC's principal railroad subsidiary to maintain its market share of the available freight has traditionally been affected by the navigational conditions on the river. As a result, the revenue per ton mile of IC's principal railroad subsidiary has generally been lower than industry averages for these commodities.

In recent years, there has been significant consolidation of rail systems in the United States. The resulting larger rail systems are able to offer seamless services in larger market areas and effectively compete with the Company in certain markets. The merger of CN and IC is expected to enhance the competitive ability of CN and IC as a combined entity. There can be no assurance that the combined company will be able to compete effectively against current and future competitors in the railroad industry and that further consolidation within the railroad industry would not adversely affect CN's and IC's competitive position. No assurance can be given that competitive pressures will not lead to reduced revenues, profit margins or both.

Integration of operations

The merger of CN and IC will involve the integration of two companies that have previously operated independently, with focuses on different geographic market segments. No assurance can be given that CN will be able to integrate the operations of IC without encountering difficulties or experiencing the loss of key IC employees or customers, or that the benefits expected from such integration will be realized.

Environment

The Company's operations are subject to federal, provincial, state, municipal and local regulations under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances and other materials, decommissioning of underground and aboveground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate ownership, operation or control, and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railroad operations and relating to its past and present ownership, operation or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities.

As at December 31, 1998, the Company had aggregate accruals for environmental costs of $65 million ($76 million at December 31, 1997). The Company has not included any reduction in costs for anticipated recovery from insurance.

IC is aware of approximately 10 contaminated sites at which it is probably liable for some portion of any required clean-up. Of these, four involve contamination primarily by diesel fuel which can be remediated without material cost. Five other sites are each expected to require more than U.S.$1 million in clean-up costs. At four of these sites, other parties are expected to contribute the majority of the costs incurred. IC paid approximately U.S.$0.7 million toward the investigation and remediation at all sites in 1998 and anticipates incurring approximately U.S.$1 million to U.S.$2 million in each of the next three years. At December 31, 1998, IC estimated the probable range of its liability to be U.S.$7.5 million to U.S.$29.8 million, and in accordance with the provisions of Statement of Financial Accounting Standards (FAS) 5, "Accounting for Contingencies," had a reserve of U.S.$7.5 million for environmental contingencies. This amount is not reduced for potential insurance recoveries or third-party contributions.

Illinois Central Railroad (ICRR), IC's principal operating subsidiary, is one of several defendants in a New Orleans class action in which a jury returned a verdict against ICRR of U.S.$125 million in punitive damages as a result of a tank car fire. The Louisiana Supreme Court vacated the judgment for technical reasons and remanded the case to the trial court for further proceedings. On June 17, 1998, the trial court re-entered judgment in favor of the class and certified it for interlocutory appeal. The case awaits hearing in the trial court on post-trial motions. While the final outcome of this proceeding cannot be determined, in the opinion of IC's management, based on present information, the ultimate resolution of this case is not expected to have a material adverse effect on IC's financial position, results of operations, cash flow or liquidity.

In the operation of a railroad, it is possible that derailments, explosions or other accidents may occur that could cause harm to human health or to the environment. As a result, the Company may incur costs in the future which may be material, to address any such harm, including costs relating to the performance of clean-ups, natural resource damage and compensatory or punitive damages relating to harm to individuals or property.

Because the ultimate cost of known contaminated sites cannot be definitely established and because additional contaminated sites yet unknown may be discovered or future operations may result in accidental releases, no assurance can be given that the Company will not incur material environmental liabilities in the future.

Legal actions

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1998 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position or the results of operations.

Labor negotiations

The Company's collective agreements with all Canadian unions expired on December 31, 1997. Following bargaining from late 1997 to mid-1998, all of the unionized workforce in Canada had concluded and ratified three-year collective agreements as of the end of 1998.

The Company is also in negotiation with bargaining units in the United States. The Company is currently engaged in mediation with three units. Under the mediation process, the parties are required to continue discussions until the mediator declares an impasse and releases the parties. There is no time limit on the duration of the mediation phase. If such mediation is unsuccessful, the union could commence a work stoppage as early as 30 days after the declaration of an impasse by the mediator. A strike would likely have the effect of shutting down certain of the Company's operations for the duration of the strike. Such a strike could have a material adverse effect on the Company's financial condition and its results of operations.

Approximately 90% of IC's employees are represented by one of 11 unions. The general approach to labor negotiations by Class I railroads in the United States is to bargain on a collective national basis. For several years now, one of IC's guiding principles is that local – rather than national, industry-wide – negotiations will result in labor agreements that better address both employees' concerns and preferences, and IC's actual operating environment. To date, all of IC's principal railroad subsidiary's 11 bargaining units have ratified local agreements that resolve wage and work-rule issues through 1999 for non-operating crafts and through the year 2000 for engineers and trainmen. At CCP Holdings, Inc., labor negotiations are local as well. Maintenance-of-way, laborer and machinist employees ratified agreements in 1998. Negotiations are ongoing with bargaining units representing signal, electrician, clerical, train and engine employees. Until new agreements are reached, cost-of-living allowance provisions and other terms in previous agreements will continue. There are risks associated with negotiating locally. Presidents and Congress have repeatedly demonstrated they will step in to avoid national strikes, while local disputes may not generate federal intervention, making an extended work stoppage more likely. IC's management believes the potential mutual benefits of local bargaining outweigh the risk.

Regulation

The Company's Canadian rail operations are subject to regulation by the Canadian Transportation Agency (CTA) and the federal Minister of Transport under the CTA, the Railway Safety Act (Canada) and certain other statutes. The Company's U.S. rail operations are subject to regulation by the STB. In addition, the Company is subject to a variety of health, safety, labor, environmental and other regulations, all of which can affect its competitive position and profitability.

Year 2000 readiness disclosure

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the Year 2000 as 1900 or some other date, resulting in errors when information using Year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the Company's ability to conduct normal business operations.

Information systems are significant to the day-to-day operations of the Company. Failure to achieve Year 2000 compliance by the Company, other railroads, customers, partners or suppliers could materially adversely affect the Company's operations. In its analysis of worst case scenario, the Company is unable to predict failures in the Canadian economy. Any failure by utilities or telecommunication providers could have a material adverse effect on the financial condition and results of operations of the Company.

In 1996, the Company initiated the work to ensure that all of its computer systems are Year 2000 ready, including the identification of operating and information systems and equipment which require remedial action. The systems plan is now complete with critical traffic and support systems converted. Conversion of desktop platforms is targeted for completion in mid-1999. Detailed plans, accountability and action items are being implemented for process control, equipment, buildings, networks, end-user systems, customers, partners and suppliers. The Company has contacted its customers, partners and suppliers indicating that their Year 2000 compliance is critical in maintaining a commercial relationship. A large portion of these third parties have responded to the Company noting that their Year 2000 plans are progressing well. Furthermore, a list of critical customers, partners and suppliers has been established. Business interruption and contingency plans are either in place or under development for all critical areas, including back-up operating and information systems, alternative suppliers, increased inventory levels and sufficient lines of credit. In 1998, the Company engaged the services of independent consultants to review the management of the Year 2000 project. The conclusion was that the Company has a well planned and structured Year 2000 program effort. A second independent analysis of the Company's Year 2000 project is being conducted in early 1999 with follow-up action as necessary.

An Executive Steering Committee and Program Management Office have been established to focus all actions that must be taken to ensure the Company minimizes the risks associated with the Year 2000 issue. Progress towards Year 2000 compliance is monitored on a regular basis by the Senior Executive Committee of the Company as well as the Board of Directors. The Company has completed all critical components of the plan and no information technology projects were deferred as a result of the Year 2000 project that would have a material adverse effect on the financial condition and results of operations of the Company.

To date, the Company has expensed approximately $27 million regarding the Year 2000 project. Based on current information, the Company has estimated the total project cost to be approximately $35 million, which will continue to be expensed as incurred. The cost of the Year 2000 project is being funded from cash from operations. While there can be no assurance that all aspects of the Year 2000 issue affecting the Company, including those related to the efforts of customers, suppliers and other third parties, will be fully resolved and that the Company will not be materially adversely affected by Year 2000 problems, the Company is committed to ensuring that it is fully Year 2000 ready. Based on current information, the Company does not believe any issues relating to the Year 2000 will have a material adverse effect on its financial condition or its results from operations.

Based on recent assessments, IC determined that it will be required to modify or replace portions of its software so that its computer systems will properly utilize dates beyond December 31, 1999. IC presently believes that with modifications to existing software and conversions to new software, the Year 2000 issue can be mitigated. However, if such modifications and conversions are not made, or are delayed, the Year 2000 issue could have a material adverse impact on the operations of IC.

IC has initiated formal communications with all of its suppliers and large customers to determine the extent to which IC is vulnerable to those third parties' failure to remediate their own Year 2000 issues. There can be no guarantee that the systems of other companies on which IC's systems rely will be converted on a timely basis, or that a failure to convert by another company, or a conversion that is incompatible with IC's systems, would not have a material adverse effect on IC.

In October 1997, IC entered into an agreement to replace approximately 40% of its non-Year 2000 compliant programs with new software and will utilize both internal and external resources to replace and test the software for Year 2000 modifications. IC began converting its remaining computer systems with internal resources in 1997. IC expects to spend approximately U.S.$10 million from 1997 through 1999 to modify and replace its computer systems. Of the total project cost, approximately U.S.$3 million is attributable to the purchase of new software. IC completed conversion of non-Year 2000 compliant programs during 1998. However, user acceptance testing will continue into 1999. Installation of new software programs should be completed during the first quarter of 1999. The total cost of the project is being funded through operating cash flows. Maintenance or modification costs will be expensed as incurred, while the costs of new software will be capitalized and amortized over the software's useful life. Accordingly, IC does not expect the amounts required to be expensed over the next two years to have a material effect on its financial position or results of operations. The amount expensed in 1997 was immaterial.

The costs of the project and the date on which CN and IC plan to complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events including the continued availability of certain resources, third-party modification plans and other factors. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those plans. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties. Based on current information, the Company does not believe any issues relating to the Year 2000 will have a material adverse effect on its financial condition or its results from operations.

Financial instruments

Although the Company conducts its business and receives revenues primarily in Canadian dollars, a portion of its revenues, expenses and debt are denominated in U.S. dollars. Thus, the Company's results are affected by fluctuations in the exchange rate between these currencies. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby affect the Company's revenues.

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. The Company has entered into a forward exchange contract (currency swap) with respect to its 15-year Swiss franc bonds. This forward exchange contract acts as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred any significant net gains or losses in respect of this transaction. Losses due to non-performance by the counterparty to its foreign currency swap are not anticipated. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. However, the credit standing of counterparties is regularly monitored.

The Company uses derivative financial instruments from time to time to hedge the exposure to interest rate fluctuations on anticipated transactions.

The Company has a hedging program in place to mitigate the effects of fuel price changes on its operating margins and overall profitability. Various swaps and collar agreements are in place to mitigate the risk of fuel price volatility for which the Company has incurred costs of $17 million in 1998. Hedging positions and credit ratings of counterparties are monitored and losses due to counterparty non-performance are not anticipated. At December 31, 1998, the Company has hedged approximately 30% of the estimated 1999 fuel consumption. Unrecognized losses from the Company's fuel hedging activities amounted to $8 million as at December 31, 1998.

Other risks

In any given year, the Company, like other railroads, is susceptible to changes in the economic conditions of the industries and geographic areas that produce and consume the freight it transports. Many of the goods and commodities carried by the Company experience cyclicality in demand. However, many of the bulk commodities the Company transports move offshore and are impacted more by global economic conditions than North American economic cycles. The Company's results of operations can be expected to reflect this cyclicality because of the significant fixed costs inherent in railroad operations. The Company's revenues are affected by prevailing economic conditions, and should an economic slowdown or recession occur in North America or other key markets, the volume of rail shipments carried by the Company is likely to be reduced.

In addition to the inherent risks of the business cycle, the Company is occasionally susceptible to severe weather conditions. For example, in late 1996 and the first quarter of 1997, CN's operations in western Canada were impacted by heavy snowfalls and severe cold weather which caused blockages on the main line serving Vancouver and led to equipment failures, temporarily halting train operations. In the first quarter of 1998, a severe ice storm hit eastern Canada, which disrupted operations and service for the railroad as well as CN customers.

Generally accepted accounting principles require the use of historical cost as the basis of reporting in financial statements. As a result, the cumulative effect of inflation, which has significantly increased asset replacement costs for capital-intensive companies such as the Company, is not reflected in operating expenses. Depreciation charges on an inflation-adjusted basis, assuming that all operating assets are replaced at current price levels, would be substantially greater than historically reported amounts.

MANAGEMENT REPORT

The accompanying consolidated financial statements of Canadian National Railway Company and all information in this annual report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management in conformity with generally accepted accounting principles in Canada. These statements include some amounts that are based on best estimates and judgments. Financial information used elsewhere in the annual report is consistent with that in the financial statements.

Management of the Company, in furtherance of the integrity and objectivity of data in the financial statements, has developed and maintains a system of internal accounting controls and supports an extensive program of internal audits. Management believes that this system of internal accounting controls provides reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements, and that assets are properly accounted for and safeguarded.

The Board of Directors carries out its responsibility for the financial statements in this report principally through its Audit and Finance Committee, consisting solely of outside directors. The Audit and Finance Committee reviews the Company's annual consolidated financial statements and recommends their approval by the Board of Directors. Also, the Audit and Finance Committee meets regularly with the Chief, Internal Audit, and with the shareholders' auditors.

These consolidated financial statements have been audited by the shareholders' auditors, KPMG LLP, whose report is presented below.

Michael J. Sabia
Executive Vice-President and Chief Financial Officer

January 19, 1999

AUDITORS' REPORT

To the shareholders of Canadian National Railway Company

We have audited the consolidated balance sheets of Canadian National Railway Company as at December 31, 1998 and 1997 and the consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and 1997, and the results of its operations and the changes in its financial position for each of the years in the three-year period ended December 31, 1998, in accordance with generally accepted accounting principles in Canada.

KPMG LLP

KPMG LLP
Chartered Accountants

Montreal, Canada
January 19, 1999

In millions, except per share data — *Year ended December 31,*	1998	1997	1996
Revenues			
Industrial products	$ 874	$ 863	$ 827
Forest products	851	824	787
Grain and grain products	554	692	564
Coal, sulfur, and fertilizers	644	665	642
Intermodal	762	776	677
Automotive	385	435	389
Other items	74	97	109
Total revenues	4,144	4,352	3,995
Operating expenses			
Labor and fringe benefits	1,456	1,459	1,405
Material	270	316	297
Fuel	249	335	314
Depreciation and amortization	210	200	194
Operating taxes	172	186	171
Equipment rental	207	219	216
Net car hire	83	116	108
Purchased services	338	363	348
Casualty and insurance	66	75	61
Other	256	276	271
Special charges *(Note 14)*	590	–	381
Total operating expenses	3,897	3,545	3,766
Operating income	247	807	229
Interest expense *(Note 15)*	(244)	(118)	(114)
Equity in earnings of Illinois Central Corporation *(Note 3)*	86	–	–
Other income *(Note 16)*	35	53	24
Foreign exchange (loss) gain	(9)	4	3
Income from continuing operations before income taxes	115	746	142
Income tax (expense) recovery from continuing operations *(Note 17)*	(6)	(325)	694
Income from continuing operations	109	421	836
Discontinued operations (net of applicable income taxes) *(Note 18)*	–	(18)	14
Net income	$ 109	$ 403	$ 850
Basic earnings per share (Note 20)			
Income from continuing operations	$ 1.19	$ 4.95	$ 9.85
Net income	$ 1.19	$ 4.74	$10.01

See accompanying notes to consolidated financial statements.

In millions *December 31,*	1998	1997
Assets		
Current assets:		
Cash and cash equivalents	$ 263	$ 365
Accounts receivable *(Note 5)*	404	681
Material and supplies	132	150
Deferred income taxes *(Note 17)*	133	241
Other	118	112
	1,050	1,549
Properties *(Note 6)*	5,442	5,122
Deferred income taxes *(Note 17)*	280	164
Investment in Illinois Central Corporation *(Note 3)*	3,802	–
Other assets and deferred charges	290	240
Total assets	$10,864	$7,075
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable and accrued charges *(Note 8)*	$ 1,174	$1,066
Current portion of long-term debt *(Note 10)*	134	43
Other	84	96
	1,392	1,205
Other liabilities and deferred credits *(Note 9)*	1,172	813
Long-term debt *(Note 10)*	4,009	1,640
Shareholders' equity:		
Capital stock *(Note 11)*	2,873	2,016
Contributed surplus	190	190
Currency translation	7	–
Retained earnings	1,221	1,211
	4,291	3,417
Total liabilities and shareholders' equity	$10,864	$7,075

On behalf of the Board:

David G.A. McLean
Director

Paul M. Tellier
Director

See accompanying notes to consolidated financial statements.

~~Canadian GAAP~~

In millions	Issued and outstanding common shares	Capital stock	Contributed surplus	Currency translation	Retained earnings	Total shareholders' equity
Balances December 31, 1995	84.9	$ 2,012	$190	$ –	$ 104	$ 2,306
Net income	–	–	–	–	850	850
Dividends	–	–	–	–	(68)	(68)
Balances December 31, 1996	84.9	2,012	190	–	886	3,088
Net income	–	–	–	–	403	403
Stock options exercised and employee share plans *(Note 12)*	0.7	4	–	–	–	4
Dividends	–	–	–	–	(78)	(78)
Balances December 31, 1997	85.6	2,016	190	–	1,211	3,417
Net income	–	–	–	–	109	109
Shares issued in second-step acquisition of Illinois Central Corporation *(Note 3)*	10.1	824	–	–	–	824
Stock options issued in second-step acquisition of Illinois Central Corporation *(Note 3)*	–	25	–	–	–	25
Stock options exercised and employee share plans *(Note 12)*	0.2	8	–	–	–	8
Currency translation	–	–	–	7	–	7
Dividends	–	–	–	–	(99)	(99)
Balances December 31, 1998	**95.9**	**$2,873**	**$190**	**$ 7**	**$1,221**	**$4,291**

See accompanying notes to consolidated financial statements.

In millions *Year ended December 31,*	**1998**	1997	1996
Operating activities			
Income from continuing operations	**$ 109**	$ 421	$ 836
Non-cash items in income:			
Special charges *(Note 14)*	**590**	–	365
Foreign exchange loss (gain)	**9**	(4)	(3)
Depreciation and amortization *(Note 19 (D))*	**213**	202	196
Deferred income taxes *(Note 17)*	**(13)**	315	(705)
Equity in earnings of Illinois Central Corporation *(Note 3)*	**(86)**	–	–
Gain on sale of interest in joint venture	**–**	(21)	–
Changes in:			
Accounts receivable *(Note 5)*	**270**	5	59
Material and supplies	**18**	7	16
Accounts payable and accrued charges (*Note 8*)	**109**	26	146
Other net current assets and liabilities	**(10)**	(44)	(49)
Payments for workforce reduction	**(187)**	(197)	(307)
Other	**(69)**	(32)	11
Cash provided from continuing operations	**953**	678	565
Investing activities			
Net additions to properties *(Note 19 (D))*	**(494)**	(393)	(292)
Net proceeds from disposal of properties	**90**	122	64
Net proceeds from sale of interest in joint venture	**–**	23	–
Investment in Illinois Central Corporation (*Note 3*)	**(2,608)**	–	–
Other	**–**	8	1
Cash used by investing activities	**(3,012)**	(240)	(227)
Dividends paid to shareholders	**(99)**	(78)	(68)
Financing activities			
Issuance of long-term debt	**4,589**	13	1
Reduction of long-term debt	**(2,541)**	(98)	(294)
Issuance of capital stock *(Note 12)*	**8**	4	–
Cash provided from (used by) financing activities	**2,056**	(81)	(293)
Cash (used by) provided from discontinued operations *(Note 18 (C))*	**–**	(20)	10
Net (decrease) increase in cash	**(102)**	259	(13)
Cash and cash equivalents, beginning of year	**365**	106	119
Cash and cash equivalents, end of year	**$ 263**	$ 365	$ 106

See accompanying notes to consolidated financial statements.

CN's revenues are derived from the movement of a balanced and diversified mix of commodities and products predominantly originating in Canada. The Company's network extends from Halifax to Vancouver and connects to the Chicago gateway through its subsidiary, Grand Trunk Corporation. Illinois Central Corporation's network extends from Chicago, where it connects with the Company's network, to the Gulf of Mexico.

1 Summary of significant accounting policies

Except where otherwise indicated, these consolidated financial statements are expressed in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in Canada, which differ in certain respects from those in the United States as explained in Note 23. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses during the period, the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from these estimates.

A. Principles of consolidation

These consolidated financial statements include the accounts of all subsidiaries, except for those of Illinois Central Corporation (IC), which is accounted for using the equity method pending approval of control by the U.S. Surface Transportation Board (STB). The Company's investments, in which it has joint control, are accounted for using the proportionate consolidation method.

B. Revenues

Freight revenues are recognized based on the percentage of completed service method. Costs associated with movements are recognized as the service is performed.

C. Foreign exchange

The Company's U.S. operations, excluding the Company's equity investment in IC, are classified as integrated with the Canadian dollar as the functional currency and are translated into Canadian dollars and accounted for on the following basis: monetary assets and liabilities are translated at the rates in effect at the balance sheet date; non-monetary assets and liabilities are translated at historical exchange rates; revenues and expenses are translated at average exchange rates during the year except for depreciation, which is translated at exchange rates prevailing when the related properties were acquired; and other currency gains and losses are reflected in net income for the year. The Company's own foreign denominated assets and liabilities are accorded similar treatment.

The Company's equity investment in IC, considered a self-sustaining foreign entity with the U.S. dollar as its functional currency, is translated into Canadian dollars at the rate in effect at the balance sheet date. The equity in earnings of IC is translated at average exchange rates during the year.

The Company has designated all of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's U.S. dollar denominated debt, are included in Currency translation, which forms part of Shareholders' equity, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC.

D. Cash and cash equivalents

Cash and cash equivalents include highly liquid investments purchased three months or less from maturity and are stated at cost, which approximates market value.

E. Material and supplies

The inventory is valued at weighted-average cost for ties and rails, latest invoice price for fuel and new materials in stores, and at estimated utility or sales value for usable secondhand, obsolete and scrap materials.

F. Properties

Railroad properties are carried at cost less accumulated depreciation including asset impairment write-downs. All costs of materials associated with the installation of rail, ties, ballast and other track improvements are capitalized to the extent they meet the Company's definition of "unit of property." The related labor and overhead costs are also capitalized for the installation of new, non-replacement track. All other labor and overhead costs and maintenance costs are expensed as incurred. Related interest costs are charged to expense. Additions to other property and equipment include the cost of developing computer software for internal use.

The cost of railroad properties, less salvage value, retired or disposed of in the normal course of business, is charged to accumulated depreciation, in accordance with the group method of depreciation. The Company reviews the carrying amounts of properties whenever events or changes in circumstances indicate that such carrying amounts may not be recoverable based on future undiscounted cash flows or estimated net realizable value. Assets that are deemed impaired as a result of such review are recorded at the lower of carrying amount or fair value.

G. Depreciation

The cost of properties, net of asset impairment write-downs, is depreciated on a straight-line basis over their estimated useful lives as follows:

Asset class	Annual rate
Track and roadway	2%
Buildings	3%
Rolling stock	3%
Other	2%

The Company performs periodic reviews of its depreciation rates. Adjustments to rates resulting from such reviews have not had a material impact on operating results.

H. Pensions
Pension costs are determined periodically by independent actuaries. Pension expense is charged to operations and includes:

(i) the cost of pension benefits provided in exchange for employees' services rendered during the year,

(ii) the amortization of the initial net transition obligation over the expected average remaining service life of the employee group covered by the plans,

(iii) the amortization of past service costs and amendments over the expected average remaining service life of the employee group covered by the plans, and

(iv) the interest cost of pension obligations, the return on pension fund assets, and the amortization of experience gains and losses.

The pension plans are funded through contributions determined in accordance with the projected unit credit actuarial cost method.

I. Post-retirement benefits other than pensions
The Company accrues the cost of post-retirement benefits other than pensions, which include life insurance programs, medical benefits, supplemental pension allowances, and free rail travel benefits not covered in the Company's principal pension plans. The Company funds the benefits payable as they become due.

J. Financial instruments
Derivative financial instruments may be used from time to time by the Company in the management of its fuel, interest rate and foreign currency exposures. Gains or losses on such instruments entered into for the purposes of hedging financial risk exposures are deferred and amortized in the results of operations over the life of the hedged asset or liability or over the terms of the derivative financial instrument. Income and expense related to financial instruments are recorded in the same category as that generated by the underlying asset or liability.

K. Environmental expenditures
Environmental expenditures that relate to current operations are expensed or capitalized as appropriate. Expenditures that relate to an existing condition caused by past operations, and which are not expected to contribute to current or future revenue generation, are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are likely, and when the costs, based on a specific plan of action in terms of the technology to be used and the extent of the corrective action required, can be reasonably estimated.

L. Income taxes
The Company follows the asset and liability method for accounting for income taxes. Under the asset and liability method, the change in the net deferred tax asset or liability is included in income. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled.

2 Accounting changes

A. Cash flow statements
Effective in the fourth quarter of 1998, the Company adopted the Canadian Institute of Chartered Accountants' (CICA) recommendations related to the presentation of cash flow statements. The standard requires that, among other things, non-cash items be excluded from investing and financing activities and disclosed elsewhere in the consolidated financial statements in a way that provides all relevant information about investing and financing activities. The standard requires retroactive application with prior comparative information being restated.

B. Computer software costs
In the first quarter of 1998, the Company adopted specific U.S. guidance related to the accounting for computer software costs as found in Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." In accordance with the requirements of this statement, this change has been applied prospectively. The impact of the adoption of SOP 98-1 was to increase net income by approximately $13 million for the year ended December 31, 1998. The Company has not applied this accounting change retroactively as the impact on prior years' comparative figures is not significant.

C. Income taxes
Effective with the fourth quarter of 1997, the Company adopted the CICA recommendations for the accounting for income taxes. The standard requires the use of the asset and liability method for accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the future income tax consequences attributable to differences between the financial statement carrying values and their respective income tax basis (temporary differences). Deferred income tax assets and liabilities are measured using enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of a change in tax rates is included in income in the period that includes the enactment date. Deferred income tax assets are evaluated and if realization is not considered "more likely than not," a valuation allowance is provided.

Previously, the Company followed the deferral method of accounting for income taxes which related the provision for income taxes to the accounting income for the period. Under the deferral method, the amount by which the income tax provision differed from the amount of income taxes currently payable was considered to represent the deferring to future periods of benefits obtained or expenditures incurred in the current period and accordingly was computed at current income tax rates. The accumulated income tax allocation debit or credit balance was not adjusted to reflect subsequent changes in income tax rates. Also, under the deferral method, tax benefits related to accounting losses could only be recognized in the period the loss was incurred if there was virtual certainty of realizing these benefits.

2 Accounting changes *(continued)*

As a result of the change in accounting policy, an income tax recovery (including discontinued operations) of $708 million, or $8.34 per share, was recorded in 1996 for income tax benefits related to years prior to 1997. In 1997, income tax expense of $303 million, or $3.56 per share, related to income before tax was recorded. There was no effect on the comparative figures prior to 1996.

3 Acquisition of Illinois Central Corporation

On February 10, 1998, the Company, through an indirect wholly-owned subsidiary, and IC entered into a merger agreement as subsequently amended on March 4, 1998, providing for the acquisition of IC by the Company for a purchase price of approximately U.S.$2.4 billion payable as to 75% in cash and 25% in common shares of the Company. Under the terms of the agreement, on March 14, 1998, the Company acquired, pursuant to the first-step cash tender offer, approximately 46.05 million common shares or 75% of the outstanding common shares of IC for $2,549 million (U.S.$1,796 million) or U.S.$39 per share. On June 4, 1998, the Company and IC consummated the second-step merger by exchanging the remaining 25% of the outstanding common shares of IC at an exchange ratio of 0.633 shares of the Company's common stock per IC share. As a result of the second-step merger, the remaining 25% of IC shares were exchanged for 10.1 million shares of the Company's common stock. In addition, the outstanding IC stock options were exchanged for stock options of the Company.

The cash tender offer was initially financed by a U.S.$800 million one-year term loan facility, a U.S.$800 million draw-down on a five-year revolving credit facility and cash on hand. On April 24, 1998, the Company repaid U.S.$70 million (Cdn$100 million) of the revolving credit facility with cash on hand. In June 1998, the Company issued commercial paper, backed by the revolving credit facility, for U.S.$150 million (Cdn$220 million) of which U.S.$140 million (Cdn$199 million) was used to repay a portion of the revolving credit facility. In July 1998, the Company repaid the one-year term loan facility and reduced its draw-down on the five-year revolving credit facility with proceeds from the issuance of U.S.$925 million of long-term debt and from the issuance of additional commercial paper.

The shares purchased under the cash tender offer and the shares acquired in the second-step merger were placed in a voting trust pending approval by the STB of the Company's acquisition of control of IC. The STB approval, while expected, cannot be assumed and may not be granted prior to the second quarter of 1999. Upon completion of the change in control, the Company may incur certain costs which will be charged to income.

The Company accounts for its investment in IC under the equity method of accounting in accordance with Accounting Principles Board Opinion (APB) 18, "The Equity Method of Accounting for Investments in Common Stock." IC is considered a self-sustaining foreign entity with the U.S. dollar as its functional currency. Effective April 1, 1998, the Company designated U.S.$1.8 billion of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Effective June 4, 1998, and corresponding with the completion of the second step of the IC acquisition, the Company increased that designated amount to include all of its U.S. dollar denominated debt. The result is that unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's U.S. dollar denominated debt, are included in Currency translation, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC, which forms part of Shareholders' equity.

The investment in IC at December 31, 1998 includes an investment of $3,398 million related to the acquisition of IC shares pursuant to the cash tender offer and the second-step merger, $259 million related to the translation of the investment to its current Canadian dollar equivalent, $59 million for transaction-related expenses, and $86 million of equity in the earnings of IC since the date of acquisition.

The Consolidated Statement of Income for the year ended December 31, 1998 includes various items related to the acquisition of IC, including $117-million pre-tax interest costs on debt associated with financing the cash tender offer. The $86-million equity in the earnings of IC included in the Consolidated Statement of Income for the year ended December 31, 1998 represents the Company's portion of IC's earnings from March 14, 1998, net of the amortization of the U.S.$1,800 million difference between the Company's cost to acquire IC and the underlying historical equity in net assets of IC, based on preliminary estimates of the fair values of IC's properties and equipment, and estimates of their remaining useful lives, as well as estimates of the fair values of other IC assets and liabilities. In total, items related to the IC acquisition increased net income for the year ended December 31, 1998 by $18 million. These amounts, as well as the impact of the issuance of shares pursuant to the second-step merger, increased the earnings per share by $0.13 for the year ended December 31, 1998. Excluding the 1998-special charge, the earnings per share decreased by $0.13. The impact of the results of the final valuation of IC's assets and liabilities and changes in accounting practices are not expected to have a material impact on the results of operations.

If the Company had acquired its investment in IC on January 1, 1997, based on the historical amounts reported by IC, net of the amortization of the difference between the Company's cost to acquire IC and the underlying historical equity in net assets of IC (based on preliminary estimates of the fair values of IC's properties and equipment, and estimates of their remaining useful lives, as well as estimates of the fair values of other IC assets and liabilities), income from continuing operations would have been $132 million ($1.38 per share) for the year ended December 31, 1998 (excluding special charges recorded by IC related to the merger)

compared to $450 million ($4.72 per share) for 1997. Income from continuing operations would have included equity in earnings of IC of $128 million for the year ended December 31, 1998 (excluding special charges recorded by IC related to the merger), compared to $119 million for 1997. Income from continuing operations would also have included after-tax interest expense related to the acquisition of $87 million for the year ended December 31, 1998 compared to $90 million for 1997. The pro-forma figures do not reflect synergies, and accordingly, do not account for any potential increases in operating income, any estimated cost savings, facilities consolidation or adjustments to conform accounting practices.

4 Illinois Central Corporation consolidated financial information

Summary financial information for IC, on its historical cost basis, for the years ended December 31, 1998, 1997 and 1996, and as at December 31, 1998 and 1997, as provided by IC's management, is presented below:

Illinois Central Corporation
Condensed Consolidated Statement of Income *(U.S. GAAP)*

In millions of U.S.$ *Year ended December 31,*	1998	1997	1996
Revenues	**$728.8**	$699.8	$657.5
Operating expenses	**521.2**	435.9	416.3
Operating income	**207.6**	263.9	241.2
Other income	**9.3**	6.0	8.6
Interest expense	**(41.2)**	(40.0)	(34.1)
Income before income taxes	**175.7**	229.9	215.7
Income tax expense	**(70.1)**	(79.7)	(79.1)
Net income	**$105.6**	$150.2	$136.6

Operating expenses for the year ended December 31, 1998 included special charges of U.S.$48.5 million (U.S.$41.2 million after tax) for severance and other costs related to the merger.

Illinois Central Corporation
Condensed Consolidated Balance Sheet *(U.S. GAAP)*

In millions of U.S.$ *December 31,*	1998	1997
Assets		
Current assets	**$ 249.9**	$ 199.2
Non-current assets	**1,923.9**	1,810.2
Total assets	**$2,173.8**	$2,009.4
Liabilities and stockholders' equity		
Current liabilities	**$ 297.0**	$ 255.1
Long-term debt	**557.3**	572.2
Deferred taxes	**442.8**	409.2
Other liabilities	**130.2**	130.1
Stockholders' equity	**746.5**	642.8
Total liabilities and stockholders' equity	**$2,173.8**	$2,009.4

5 Accounts receivable

In millions *December 31,*	1998	1997
Freight		
Trade	**$217**	$504
Accrued	**48**	43
Non-freight	**180**	178
	445	725
Provision for doubtful accounts	**(41)**	(44)
	$404	$681

On June 25, 1998, the Company entered into a revolving agreement to sell eligible freight trade receivables. The agreement, which expires in June 2003, allows for sales of freight trade receivables up to a maximum of $250 million. At December 31, 1998, $150 million and U.S.$45 million (Cdn$69 million) had been sold on a limited recourse basis, pursuant to the agreement. The Company has retained the responsibility for servicing and collecting the accounts receivable sold. Costs related to the agreement, which fluctuate with changes in prevailing interest rates, are included in Other income.

6 Properties

In millions	*December 31, 1998*			*December 31, 1997*		
	Cost	Accumulated depreciation	Net	Cost	Accumulated depreciation	Net
Track and roadway	**$ 6,641**	**$3,059**	**$3,582**	$ 6,503	$3,107	$3,396
Buildings	**875**	**517**	**358**	836	508	328
Rolling stock	**2,296**	**1,059**	**1,237**	2,248	1,073	1,175
Other	**774**	**509**	**265**	735	512	223
	$10,586	**$5,144**	**$5,442**	$10,322	$5,200	$5,122
Capital leases included in properties	**$ 617**	**$ 72**	**$ 545**	$ 499	$ 50	$ 449

7 Credit facilities

In connection with the acquisition of IC, the Company entered into a U.S.$800 million one-year term loan facility and a U.S.$1,000 million five-year revolving credit facility. Concurrently, the Company terminated its previous revolving credit facilities. The credit facilities provide for interest on borrowings at various interest rates including the Canadian prime rate, bankers' acceptance rates, the U.S. federal funds effective rate and the London Interbank Offer Rate plus applicable margins. The credit facility agreements contain customary financial covenants, based on U.S. generally accepted accounting principles, including i) limitations on debt as a percentage of total capitalization, ii) maintenance of tangible net worth above predefined levels and iii) maintenance of the fixed charge coverage ratio above predefined levels. The Company was in compliance with all of these financial covenants throughout the year. In July 1998, the Company repaid the one-year term loan facility and reduced its draw-down on the five-year revolving credit facility with proceeds from the issuance of U.S.$925 million of long-term debt and from the issuance of commercial paper. The Company's commercial paper program is backed up by the five-year revolving credit facility. As at December 31, 1998, the Company had U.S.$347 million (Cdn$532 million) of commercial paper outstanding and U.S.$220 million (Cdn$337 million) outstanding under the revolving credit facility.

8 Accounts payable and accrued charges

In millions *December 31,*	**1998**	1997
Trade payables	**$ 279**	$ 314
Current portion of workforce reduction provisions	**235**	177
Payroll-related accruals	**177**	172
Accrued charges	**121**	119
Accrued interest on long-term debt	**111**	46
Accrued operating leases	**85**	112
Other	**166**	126
	$1,174	$1,066

9 Other liabilities and deferred credits

In millions *December 31,*	**1998**	1997
Workforce reduction provisions, net of current portion *(A)*	**$ 590**	$281
Accrual for post-retirement benefits other than pensions *(B)*	**149**	135
Personal injury reserve	**108**	88
Environmental reserve, net of current portion	**38**	59
Deferred credits and other	**287**	250
	$1,172	$813

A. Workforce reduction provisions

The workforce reduction provisions, which cover employees in both Canada and the United States, are mainly comprised of severance payments which will be disbursed over a period of up to six years. Other elements of the provisions mainly include early retirement incentives and bridging to early retirement. Payments for severance and other elements of the provisions have reduced the provisions by $187 million for the year ended December 31, 1998 ($197 million for the year ended December 31, 1997). The special charge recorded in 1998 with respect to workforce reductions, excluding the related pension curtailment, had the effect of increasing the aggregate provisions to $825 million at December 31, 1998.

B. Post-retirement benefits other than pensions

(i) The following table shows the reconciliation of the plan's obligations to amounts accrued at the balance sheet dates. The Company uses a December 31 measurement date.

In millions *December 31,*	**1998**	1997
Accumulated post-retirement benefit obligation:		
Retirees	**$ 82**	$ 65
Fully eligible active plan participants	**62**	61
	144	126
Unrecognized net gain	**5**	9
	$149	$135

(ii) Components of net periodic post-retirement benefit cost applicable to continuing operations are as follows:

In millions *Year ended December 31,*	**1998**	1997	1996
Service cost	**$ 4**	$ 3	$ 3
Interest cost	**10**	7	6
Net amortization and deferral	**7**	(1)	(7)
	$21	$ 9	$ 2
Weighted-average discount rate	**7.50%**	7.44%	8.00%
Weighted-average (long-term) salary increase	**4.25%**	4.50%	5.25%

10 Long-term debt

In millions	Maturity	Currency in which payable	*December 31* 1998	1997
Bonds, debentures, and notes: (A) (B)				
Canadian National series:				
9⅝% 7-year notes	May 14, 1999	Cdn$	$ 50	$ 50
5⅜% 15-year Swiss franc bonds *(C)*	Aug. 22, 2000	CHF	99	99
8⅞% 15-year notes	May 21, 2001	Cdn$	150	150
6⅝% 10-year notes	May 15, 2003	U.S.$	190	190
7% 10-year notes	Mar. 15, 2004	U.S.$	365	365
6.45% Puttable Reset Securities (PURS) *(D)*	July 15, 2006	U.S.$	355	–
6.80% 20-year notes *(E)*	July 15, 2018	U.S.$	284	–
7⅝% 30-year debentures	May 15, 2023	U.S.$	190	190
6.90% 30-year notes *(E)*	July 15, 2028	U.S.$	674	–
Total bonds, debentures, and notes			2,357	1,044
Other: (A)				
Revolving credit facility *(Note 7)*		U.S.$	312	–
Commercial paper *(F)*		U.S.$	493	–
Mortgages		Cdn$	15	15
Amounts owing under equipment agreements *(G)*		Various	65	75
Capital lease obligations *(H)*		Various	578	477
Adjustment to current exchange rate *(A)*			331	75
Total other			1,794	642
Subtotal			4,151	1,686
Less:				
Current portion of long-term debt			134	43
Net unamortized discount			8	3
			142	46
			$4,009	$1,640

A. U.S. dollar denominated long-term debt amounts are reflected in Canadian dollars at the rate in effect at the time of the issuance of the long-term debt. The effect of the current exchange rate conversion is included in "Adjustment to current exchange rate."

B. The Company's bonds, debentures, and notes are unsecured.

C. The August 22, 2000 bonds issued in Swiss francs (CHF170 million), bearing an interest rate of 5⅜%, were effectively converted at their issue date to a $99-million Canadian dollar obligation through a currency swap agreement at an all-inclusive cost of 11.17%.

D. The PURS contain imbedded simultaneous put and call options at par. At the time of issuance, the Company sold the option to call the securities on July 15, 2006 (the reset date). If the call option is exercised, the imbedded put option is automatically triggered, resulting in the redemption of the original PURS. The call option holder will then have the right to remarket the securities at a new coupon rate for an additional 30-year term ending July 15, 2036. The new coupon rate will be determined according to a pre-set mechanism based on market conditions then prevailing. If the call option is not exercised, the put option is deemed to have been exercised, resulting in the redemption of the PURS on July 15, 2006.

E. The 20-year and 30-year notes are redeemable, in whole or in part, at the option of the Company, at any time, at the greater of par and a formula price based on interest rates prevailing at the time of redemption.

F. During 1998, the Company initiated a commercial paper program. The program enables the Company to issue commercial paper up to a maximum aggregate principal amount of $600 million or the U.S. dollar equivalent and is supported by the revolving credit facility. Commercial paper debt is due within one year but has been classified as long-term debt, reflecting the Company's intent and ability to refinance the short-term borrowing through subsequent issuances of commercial paper or drawing down on the revolving credit facility.

G. These agreements are secured by rolling stock and payable by monthly or semi-annual installments over various periods to 2003 at interest rates ranging from 6% to 13¾%. The principal amounts are payable as follows: $44 million and U.S.$16 million (Cdn$25 million) as at December 31, 1998, and $49 million and U.S.$19 million (Cdn$28 million) as at December 31, 1997.

10 Long-term debt *(continued)*

H. Interest rates for these leases range from approximately 4¾% to 14¼% with maturity dates in the years 1999 through 2016. The imputed interest on these leases amounted to $530 million as at December 31, 1998 and $460 million as at December 31, 1997.

I. Principal repayments for the following fiscal years, including repurchase arrangements and capital lease repayments on debt outstanding as at December 31, 1998 but excluding repayments of commercial paper of $532 million (U.S.$347 million) and amounts related to the revolving credit facility of $337 million (U.S.$220 million), are as follows:

Year	*In millions* Amount
1999	$ 134
2000	179
2001	215
2002	22
2003	245
2004 and thereafter	2,479

J. The aggregate amount of debt payable in U.S. currency as at December 31, 1998 is U.S.$2,343 million (Cdn$3,590 million) and as at December 31, 1997 is U.S.$800 million (Cdn$1,143 million).

K. During 1998, the Company recorded $156 million in capital lease obligations ($213 million in 1997) related to rolling stock financing.

11 Capital stock

A. Authorized capital stock

The authorized capital stock of the Company is as follows:

- Unlimited number of Common Shares, without par value
- Unlimited number of Class A Preferred Shares, without par value issuable in series
- Unlimited number of Class B Preferred Shares, without par value issuable in series

B. Issued and outstanding common shares

During 1998, the Company issued 10.1 million common shares as a result of the second-step merger with IC. The Company also issued 0.2 million shares related to stock options exercised and employee share plans. The total number of common shares issued and outstanding was 95.9 million as at December 31, 1998.

12 Stock plans

A. Employee share plans

(i) As part of the public offering in 1995, eligible employees purchased shares under the employee share plans. The Company provided non-interest bearing loans of up to 90% of the share purchase price to eligible employees. During 1998, the Company issued a total of 47,778 common shares (matched shares) to those employees whose shares in the plans had vested during the year. An additional 22,506 common shares will be issued by the Company once their vesting requirements are met.

(ii) Effective September 1, 1997, an Employee Share Investment Plan (ESIP) was implemented giving eligible employees the opportunity to subscribe for up to 6% of their gross salaries to purchase shares of the Company's common stock on the open market and to have the Company invest, on the employee's behalf, a further 35% of the amount invested by the employee. Participation at December 31, 1998 was 5,100 employees (1,893 at December 31, 1997). The total number of ESIP shares purchased on behalf of employees, including the Company's contributions, was 122,061 in 1998 and 19,203 in 1997.

B. Stock options

The Company has stock option plans for eligible managers to acquire common shares of the Company upon vesting at a price equal to the market value of the common shares at the date of granting. The options are exercisable during a period not to exceed 10 years. The right to exercise options generally accrues over a period of four years of continuous employment. Options are not generally exercisable during the first 12 months after the date of grant. At December 31, 1998, a total of 5.9 million common shares remained authorized for issuance under these plans.

Options issued by the Company include conventional options, which vest over a period of time, and performance options, which vest upon the attainment of Company targets relating to the operating ratio and unlevered return on investment. The total conventional and performance options outstanding at December 31, 1998 were 2.5 million and 1.0 million, respectively.

Changes in the Company's stock options are as follows:

	Number of options *In millions*	Weighted-average exercise price
Outstanding at December 31, 1995	1.0	$27.00
Granted	0.6	$37.20
Canceled	(0.1)	$29.32
Outstanding at December 31, 1996	1.5	$31.14
Granted	0.6	$56.59
Canceled	(0.2)	$29.50
Exercised	(0.1)	$31.06
Outstanding at December 31, 1997	1.8	$38.87
Conversion of IC options	1.5	U.S.$45.14
Granted	0.6	$74.70
Canceled	(0.2)	$40.44
Exercised (1)	(0.2)	$38.84
Outstanding at December 31, 1998 (1)	**3.5**	**$58.22**

(1) Includes the IC converted stock options translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

Stock options outstanding as at December 31, 1998 were as follows:

	Options outstanding				Options exercisable	
	Range of exercise prices	Number of options	Weighted-average years to expiration	Weighted-average exercise price	Number of options	Weighted-average exercise price
		In millions			*In millions*	
Options granted in 1995	$27.00	0.5	4	$27.00	0.3	$27.00
Options granted in 1996	$37.04–$47.44	0.4	4	$37.27	0.1	$37.50
Options granted in 1997	$49.70–$77.50	0.5	6	$56.78	–	$58.81
Options granted in 1998 (1)	$12.91–$93.70	2.1	8	$71.02	1.5	$69.43
Balance at December 31, 1998 (1)		**3.5**	**6**	**$58.22**	**1.9**	**$60.74**

(1) Includes the IC converted stock options translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

13 Pensions

The Company has retirement benefit plans under which substantially all employees are entitled to benefits at retirement age, generally based on compensation and length of service and/or contributions. The table that follows pertains to all such plans. However, the following descriptions relate solely to the Company's main pension plan, the CN Pension Plan. The Company's other pension plans are not significant.

Description of plan

The CN Pension Plan (the Pension Plan) is a contributory defined benefit pension plan that covers substantially all CN employees. It provides for pensions based mainly on years of service and final average pensionable earnings and is generally applicable from the first day of employment. Indexation of pensions is provided after retirement through a gain (loss) sharing mechanism, subject to guaranteed minimum increases. An independent trust company is the Trustee of the Canadian National Railways Pension Trust Funds (CN Pension Trust Funds). As Trustee, the trust company performs certain duties which include holding legal title to the assets of the CN Pension Trust Funds and ensuring that the Company, as Administrator, complies with the provisions of the Pension Plan and the related legislation.

Funding policy

Employee contributions to the Pension Plan are determined by the plan rules. Company contributions are in accordance with the requirements of Government of Canada legislation, The Pension Benefits Standards Act, 1985, and are determined by actuarial valuations conducted at least on a triennial basis. These valuations are made in accordance with legislative requirements and with the recommendations of the Canadian Institute of Actuaries for the valuation of pension plans.

Description of fund assets

The assets of the CN Pension Plan are separately accounted for in the CN Pension Trust Funds. These assets consist of cash and short-term investments, bonds, mortgages, Canadian and foreign equities, real estate, and oil and gas assets.

The actuarial valuations as at December 31, 1997 indicated a consolidated actuarial liability of $8,736 million and a consolidated actuarial asset value of $8,668 million. It is estimated that those amounts approximate $8,990 million and $9,070 million, respectively, as at December 31, 1998. Subsequent actuarial valuations will determine the actuarial values at that date.

In millions	*Year ended December 31,* **1998**	1997	1996
Pension expense	**$57**	$50	$48
Pension contributions	**$77**	$68	$81

During 1998, the Company recorded a special charge for workforce reductions of $590 million which includes $36 million related to the curtailment of the Pension Plan. The curtailment increased the projected benefit obligation by $23 million and reduced the unrecognized transition obligation and unrecognized prior service cost by $5 million and $8 million, respectively.

14 Special charges

A. Workforce reductions

The Company recorded a charge to operations of $590 million in 1998 and $365 million in 1996 for workforce reduction plans aimed at reducing future operating costs and increasing productivity. The 1998-charge of $590 million includes severance and other payments to be made for approximately 3,000 reductions (1,400 occurred in 1998 with the remainder planned to be completed before the end of 1999). Labor productivity and operating efficiency initiatives span the entire organization with reductions in the administration, transportation, engineering and equipment functions. The majority of payments related to workforce reductions are expected to occur throughout the next six years.

B. Debt reduction costs

The charge to operations of the costs to redeem, repurchase or defease debt in 1996 amounted to $16 million.

15 Interest expense

In millions *Year ended December 31,*	**1998**	1997	1996
Interest on long-term debt	**$259**	$122	$110
Interest on short-term borrowings	**2**	2	7
Interest income	**(17)**	(6)	(3)
Total continuing operations	**$244**	$118	$114
Cash interest payments for continuing operations	**$194**	$110	$119

16 Other income

In millions *Year ended December 31,*	**1998**	1997	1996
Gain on disposal of properties	**$ 51**	$ 37	$ 26
Investment income	**12**	9	10
Net rental loss	**(20)**	(8)	(7)
Income (loss) from Canac Inc.	**5**	(2)	(1)
Gain on sale of interest in joint venture	**–**	21	–
Other	**(13)**	(4)	(4)
	$ 35	$ 53	$ 24

17 Income taxes

The Company's income tax (expense) recovery from continuing operations is as follows:

In millions *Year ended December 31,*	**1998**	1997	1996
Combined basic Canadian federal and provincial tax rate (combined basic tax rate)	**44.4%**	44.4%	44.4%
Income tax expense from continuing operations based on the combined basic tax rate	**$(51)**	$(331)	$ (63)
Income tax (expense) recovery resulting from:			
Federal large corporations tax and other cash taxes	**(18)**	(10)	(11)
Equity in earnings of IC	**38**	–	–
Gain on disposal of properties	**8**	4	5
Other	**17**	12	(5)
Recognition of income tax benefits related to prior years	**–**	–	768
Income tax (expense) recovery from continuing operations	**$ (6)**	$(325)	$ 694
Income tax (expense) recovery from continuing operations is represented by:			
Current	**$(19)**	$ (10)	$ (11)
Deferred	**13**	(315)	705
	$ (6)	$(325)	$ 694
Income tax recovery (expense) related to discontinued operations	**$ –**	$ 12	$ (3)
Cash payments for income taxes	**$ 18**	$ 10	$ 11

Significant components of deferred income tax assets and liabilities are as follows:

In millions *December 31,*	**1998**	1997
Deferred income tax assets		
Loss carryforwards	**$ 222**	$165
Workforce reduction provisions	**352**	178
Accruals and other reserves	**79**	42
Post-retirement benefits	**56**	45
	709	430
Deferred income tax liabilities		
Properties	**296**	25
	296	25
Total net deferred income tax asset	**413**	405
Net current deferred income tax asset	**133**	241
Net long-term deferred income tax asset	**$ 280**	$164

18 Discontinued operations

Consistent with the Company's plan to focus resources on operating a transportation network, in late 1997, the Company adopted a formal plan to exit its telecommunication business operated by a subsidiary.

In late 1996, the Company sold all the shares of CN France S.A., a wholly-owned subsidiary, to Scribe Gestion S.A. The net proceeds retained by the Company resulted in a gain of $14 million.

A. Income (loss) from discontinued operations

Amounts included in the Consolidated Statement of Income are comprised as follows:

In millions *Year ended December 31,*	**1998**	1997	1996
Net income (loss):			
CN France	**$ –**	$ –	$ 4
Telecommunication business	**–**	(6)	(4)
Net loss from discontinued operations	**–**	(6)	–
Provision for loss on disposal of telecommunication business activities, net of income tax recovery of $8 million	**–**	(12)	–
Gain on disposal of investment in CN France, net of applicable income taxes of $6 million	**–**	–	14
	–	(12)	14
Discontinued operations (net of applicable income taxes)	**$ –**	$(18)	$ 14

B. Net liabilities of discontinued operations

Amounts included in the Consolidated Balance Sheet are comprised as follows:

In millions *December 31,*	**1998**	1997
Current assets	**$10**	$18
Deferred income taxes	**6**	6
Total assets	**16**	24
Current liabilities	**19**	28
Other liabilities and deferred credits	**1**	–
Total liabilities	**20**	28
Net liabilities	**$ 4**	$ 4

C. Net (decrease) increase in cash

Amounts included in the Consolidated Statement of Cash Flows are comprised as follows:

In millions *Year ended December 31,*	**1998**	1997	1996
Operating activities	**$ –**	$(20)	$ (6)
Investing activities	**–**	–	17
Financing activities	**–**	–	(1)
Cash (used by) provided from discontinued operations	**$ –**	$(20)	$ 10

19 Segmented information

A. Geographic areas

The majority of the Company's operations and assets are within Canada with the exception of U.S. rail operations.

B. International traffic

In addition to the revenue generated by U.S. rail operations, the Company derives revenue from Canadian rail operations originating or terminating on railroads in the United States. These revenues amounted to approximately $978 million in 1998, $997 million in 1997 and $905 million in 1996.

C. Investment in Illinois Central Corporation

In February 1998, the Company and IC entered into a merger agreement pursuant to which all IC common shares acquired by the Company were placed in a voting trust pending STB approval of the Company's acquisition of control of IC. Until STB approval, the Company will account for its investment in IC using the equity method. Upon receipt of STB approval, all additional information pertaining to IC will be included in the Company's U.S. rail segment.

D. Information on geographic areas

In millions *Year ended December 31,*	**1998**	1997	1996
Revenues:			
Canadian rail	**$ 3,539**	$ 3,772	$ 3,421
U.S. rail	**605**	580	574
	$ 4,144	$ 4,352	$ 3,995
Operating income:			
Canadian rail	**$ 222**	$ 730	$ 205
U.S. rail	**25**	77	24
	$ 247	$ 807	$ 229
Income (loss) from continuing operations:			
Canadian rail	**$ 138**	$ 373	$ 867
U.S. rail	**(115)**	48	(31)
Equity in earnings of IC	**86**	–	–
	$ 109	$ 421	$ 836
Depreciation and amortization:			
Canadian rail *(i)*	**$ 203**	$ 192	$ 186
U.S. rail	**10**	10	10
	$ 213	$ 202	$ 196
Capital expenditures: (ii)			
Canadian rail *(iii)*	**$ 545**	$ 529	$ 464
U.S. rail	**70**	48	32
	$ 615	$ 577	$ 496

In millions *December 31,*	**1998**	1997
Identifiable assets:		
Canadian rail	**$ 6,703**	$ 6,606
U.S. rail	**343**	445
Investment in IC	**3,802**	–
	10,848	7,051
Discontinued operations	**16**	24
	$10,864	$ 7,075

(i) Includes $3 million (1997: $2 million, 1996: $2 million) depreciation and amortization of properties related to net rental income and Canac Inc.

(ii) Represents additions to properties.

(iii) Includes $17 million (1997: $5 million, 1996: $1 million) additions of properties related to net rental income and Canac Inc. This amount also includes non-cash capital expenditures financed with capital leases and capitalized depreciation.

20 Earnings per share

Year ended December 31,	**1998**	1997	1996
Basic earnings per share (excluding special charges)			
Income from continuing operations	**$4.96**	$4.95	$12.39
Net income	**$4.96**	$4.74	$12.56
Weighted-average number of common shares outstanding *(millions)*	**91.5**	85.1	84.9

In 1997, the Company retroactively adopted the CICA recommendations on income taxes. As a result, the 1996 earnings per share figures have been restated to include the effects of these recommendations.

21 Major commitments and contingencies

A. Leases

The Company's commitments as at December 31, 1998 under operating and capital leases totaling $1,394 million and $1,143 million, respectively, with annual net minimum payments in each of the five following fiscal years to 2004 and thereafter, are as follows:

Year *In millions*	Operating	Capital
1999	$ 231	$ 106
2000	204	85
2001	209	91
2002	202	35
2003	176	33
2004 and thereafter	372	793
	$1,394	1,143
Less: imputed interest on capital leases at rates ranging from approximately 4¾% to 14¼%		530
Present value of minimum lease payments at current rate included in debt		$ 613

B. Other commitments

As at December 31, 1998, the Company had commitments to acquire locomotives and freight cars at an aggregate cost of $149 million, rail at a cost of $43 million, railroad ties at a cost of $44 million, automotive equipment at a cost of $15 million and intermodal equipment at a cost of $2 million. Further, as at December 31, 1998, the Company had entered into car repair commitments totaling $26 million for the years 1999 to 2002 and into agreements with fuel suppliers to purchase approximately 57% of its anticipated 1999 volume at market prices prevailing on the date of the purchase.

C. Contingencies

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1998 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position.

D. Environmental matters

The Company's operations are subject to federal, provincial, state, municipal and local regulations under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances, and other materials, decommissioning of underground and aboveground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate ownership, operation or control, and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railroad operations and relating to its past and present ownership, operation or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years, based on known information, for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities. The magnitude of such additional liabilities and the costs of complying with environmental laws and containing or remediating contamination cannot be reasonably estimated due to:

(i) the lack of specific technical information available with respect to many sites;

(ii) the absence of any government authority, third-party orders, or claims with respect to particular sites;

(iii) the potential for new or changed laws and regulations and for development of new remediation technologies and uncertainty regarding the timing of the work with respect to particular sites;

(iv) the ability to recover costs from any third parties with respect to particular sites; and

therefore, the likelihood of any such costs being incurred or whether such costs would be material to the Company cannot be determined at this time. Therefore, there can be no assurance that material liabilities or costs related to environmental matters will not be incurred in the future or that the Company's liquidity will not be adversely impacted by such environmental liabilities or costs. Although the effect on operating results and liquidity cannot be reasonably estimated, management believes, based on current information, that environmental matters will not have a material adverse effect on the Company's financial condition or competitive position. Costs related to any future remediation will be accrued in the year in which they become known.

As at December 31, 1998, the Company had aggregate accruals for environmental costs of $65 million ($76 million as at December 31, 1997). During the year, $11 million was charged to the provision for environmental costs compared to $11 million in 1997 and $11 million in 1996. In addition, related environmental capital expenditures were $13 million in 1998, $13 million in 1997 and $13 million in 1996. The Company also expects to incur capital expenditures relating to environmental matters of approximately $15 million in 1999, $7 million in 2000 and $6 million in 2001. The Company has not included any reduction in costs for anticipated recovery from insurance.

E. Uncertainty due to Year 2000 issue

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the Year 2000 as 1900 or some other date, resulting in errors when information using Year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the Company's ability to conduct normal business operations. There can be no assurance that all aspects of the Year 2000 issue affecting the Company, including those related to the efforts of customers, suppliers or other third parties, will be fully resolved.

22 Financial instruments

A. Risk management

The Company has limited involvement with derivative financial instruments in the management of its fuel, interest rate and foreign currency exposures, and does not use them for trading purposes.

(i) Credit risk

The Company is exposed to credit risk in the event of non-performance by counterparties to its derivative financial instruments but does not expect such non-performance as counterparties are of high credit quality. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. However, the credit standing of counterparties is regularly monitored. The total risk associated with the Company's counterparties was immaterial at December 31, 1998. The Company believes there are no significant concentrations of credit risk.

(ii) Interest rates

In anticipation of the issuance of the U.S.$925 million of long-term debt with respect to the IC acquisition (see Note 3), the Company hedged a portion of its exposure to interest rate risk by means of forward contracts and options. The hedging cost amounting to U.S.$13 million (Cdn$19 million) is being amortized over the term of the respective debt issues.

(iii) Foreign currency

Although the Company conducts a majority of its business and receives revenues primarily in Canadian dollars, a significant portion of its business is conducted and revenues are denominated in U.S. dollars. Thus, the Company's results are affected by fluctuations in the exchange rate between these currencies. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby affect the Company's revenues.

The Company has entered into a forward exchange contract (currency swap) with respect to its 15-year Swiss franc bonds. This forward exchange contract acts as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred any significant net gains or losses in respect of this transaction. Losses due to non-performance by the counterparty to its foreign currency swap are not anticipated.

Effective April 1, 1998, the Company designated U.S.$1.8 billion of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Effective June 4, 1998, and corresponding with the completion of the second step of the IC acquisition, the Company increased that designated amount to include all of its U.S. dollar denominated debt. The result is that unrealized foreign exchange gains and losses, from the date of designation, on the translation of the Company's

22 Financial instruments *(continued)*

U.S. dollar denominated debt are included in Currency translation, along with the unrealized foreign exchange gains and losses on the translation of the Company's net investment in IC, which forms part of Shareholders' equity.

(iv) Fuel
The Company has a hedging program in place to mitigate the effects of fuel price changes on its operating margins and overall profitability. The Company has entered into various swaps and collar agreements to mitigate the risk of fuel price volatility. The Company also monitors its hedging positions and the credit ratings of its counterparties and does not anticipate losses due to counterparty non-performance. At December 31, 1998, the Company has hedged approximately 30% of the estimated 1999 fuel consumption. Unrecognized losses from the Company's fuel hedging activities amounted to $8 million at December 31, 1998.

B. Fair value of financial instruments
Generally accepted accounting principles define the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company uses the following methods and assumptions to estimate the fair value of each class of financial instruments for which the carrying amounts are included in the Consolidated Balance Sheet under the following indicated captions:

(i) Cash and cash equivalents, Accounts receivable, Accounts payable and accrued charges, and Other current liabilities:
The carrying amounts approximate fair value because of the short maturity of these instruments.

(ii) Other assets and deferred charges:
Investments: The Company has various debt and equity investments for which the carrying value approximates the fair value.

(iii) Long-term debt:
The fair value of the Company's long-term debt is estimated based on the quoted market prices for the same or similar debt instruments.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments as at December 31, 1998 and 1997 for which the carrying values are not disclosed on the Consolidated Balance Sheet or for which the carrying amounts are different from the fair values:

In millions	***December 31, 1998***		*December 31, 1997*	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial assets				
Investments	**$ 51**	**$ 51**	$ 51	$ 51
Financial liabilities				
Long-term debt	**$4,009**	**$4,108**	$1,640	$1,694

23 Reconciliation of Canadian and United States generally accepted accounting principles

The consolidated financial statements of Canadian National Railway Company are expressed in Canadian dollars and are prepared in accordance with Canadian generally accepted accounting principles (Canadian GAAP), which conform, in all material respects, with those generally accepted in the United States, except as described below:

A. Reconciliation of net income
The application of U.S. GAAP would have the following effects on the net income as reported:

In millions *Year ended December 31,*	**1998**	1997	1996
Income from continuing operations – Canadian GAAP	**$109**	$ 421	$836
Adjustments in respect of:			
Property capitalization, net of depreciation	**181**	139	–
Equity in earnings of IC	**19**	–	–
Foreign exchange	**(15)**	(43)	6
Pension and post-retirement benefit costs	**11**	9	4
Compensation expense related to stock-based compensation	**(13)**	(17)	(14)
Loss on extinguishment of long-term debt	**–**	–	16
Income tax expense	**(68)**	(40)	–
Income from continuing operations – U.S. GAAP	**224**	469	848
Discontinued operations	**–**	(18)	14
Extraordinary item – loss on extinguishment of long-term debt	**–**	–	(16)
Cumulative effect of change in accounting policy	**42**	589	–
Net income – U.S. GAAP	**$266**	$1,040	$846

(i) Property capitalization
Under Canadian GAAP, the Company capitalizes only the material component of track replacement costs, whereas effective January 1, 1997, under U.S. GAAP the labor, material and related overheads are capitalized. U.S. GAAP requires that the cumulative capitalization adjustment, including special charges (net of applicable income taxes), be reflected in net income in the year in which the policy is adopted ($589 million).

(ii) Equity in earnings of Illinois Central Corporation
Under Canadian GAAP, the Company capitalizes the material component of track replacement costs, whereas IC, under U.S. GAAP, capitalizes the labor, material and related overheads.

(iii) Foreign exchange

U.S. GAAP requires immediate recognition in income of unrealized foreign currency exchange gains and losses on long-term monetary items with a fixed or ascertainable life, whereas Canadian accounting principles require that these unrealized gains and losses be deferred and amortized. In addition, under U.S. GAAP, future revenue streams from operations do not qualify as a hedge of long-term debt denominated in U.S. dollars.

(iv) Change in accounting policy – Pensions and post-retirement benefits other than pensions

Canadian GAAP requires that the discount rate used should represent management's best estimate of the long-term rate of return on the pension fund assets. Under U.S. GAAP, the discount rate to be used should reflect the rate at which the pension benefits and post-retirement benefit costs can be effectively settled at the date of the financial statements. The difference in discount rates impacts annual pension expense and post-retirement benefit costs.

In addition, effective January 1, 1998, the Company changed its accounting policy for pension costs and adopted the corridor approach to account for experience gains and losses, as described in Statement of Financial Accounting Standards (FAS) 87, "Employers' Accounting for Pensions," and FAS 106, "Employers' Accounting for Post-retirement Benefits Other than Pensions," thereby conforming the Company's accounting practices with industry practices. Accordingly, experience gains and losses within the specified corridor were not amortized in 1998. U.S. GAAP requires that the cumulative effect of change in accounting policy (net of applicable income taxes) be reflected in net income in the year in which the policy is adopted ($42 million).

(v) Stock-based compensation

U.S. GAAP requires the measurement and recognition of compensation expense related to certain stock-based compensation. The Company has accounted for stock-based compensation for U.S. GAAP purposes in accordance with APB 25, "Accounting for Stock Issued to Employees." The difference between compensation expense measured in accordance with APB 25 and the amount which would have been recognized under FAS 123, "Accounting for Stock-based Compensation," is not material. There are no similar requirements under Canadian GAAP.

(vi) Loss on extinguishment of long-term debt

Under U.S. GAAP, the loss on extinguishment of long-term debt, which is included in special charges for Canadian GAAP purposes, would have been treated as an extraordinary item.

(vii) Income taxes

In the fourth quarter of 1997, the Company adopted the accounting recommendations for Canadian GAAP related to the accounting for income taxes which require retroactive application and restatement of comparative figures. The effect of the adoption of the accounting recommendations and restatement of financial statements was an increase in 1996 net income of $708 million. These recommendations are consistent, in all material respects, with U.S. GAAP. Under U.S. GAAP, the Company had previously reversed its valuation allowance amounting to $708 million in 1996.

B. Earnings per share

In 1997, the Company retroactively adopted FAS 128, "Earnings per Share," for computing and presenting earnings per share. As a result, the 1996 earnings per share figures have been restated to conform with FAS 128.

(i) Basic earnings per share

Year ended December 31,	**1998**	1997	1996
Income from continuing operations – U.S. GAAP	**$2.45**	$ 5.51	$ 9.99
Discontinued operations	–	(0.21)	0.16
Extraordinary item – loss on extinguishment of long-term debt	–	–	(0.19)
Cumulative effect of change in accounting policy	**0.46**	6.92	–
Net income – U.S. GAAP	**$2.91**	$12.22	$ 9.96
Weighted-average number of common shares outstanding *(millions)* – U.S. GAAP	**91.5**	85.1	84.9

(ii) Diluted earnings per share

U.S. GAAP requires the use of the treasury stock method for common stock equivalents to compute the weighted-average number of common shares outstanding for the period. The use of the treasury stock method for the matched shares and stock options issued from 1996 to 1998 has been considered in the earnings per share figures for those years as computed under U.S. GAAP.

Year ended December 31,	**1998**	1997	1996
Income from continuing operations – U.S. GAAP	**$2.42**	$ 5.44	$ 9.88
Discontinued operations	–	(0.21)	0.16
Extraordinary item – loss on extinguishment of long-term debt	–	–	(0.19)
Cumulative effect of change in accounting policy	**0.46**	6.83	–
Net income – U.S. GAAP	**$2.88**	$12.06	$ 9.85
Weighted-average number of common shares outstanding *(millions)* – U.S. GAAP	**92.4**	86.2	85.9

23 Reconciliation of Canadian and United States generally accepted accounting principles *(continued)*

(iii) Pro-forma earnings per share

The following earnings per share figures assume that the changes in accounting policies for track replacement costs and pensions and post-retirement benefits other than pensions were applied retroactively.

Year ended December 31,	**1998**	1997	1996
Basic earnings per share			
Income from continuing operations – U.S. GAAP	**$2.45**	$ 5.58	$ 4.43
Net income – U.S. GAAP	**$2.45**	$ 5.37	$ 4.40
Diluted earnings per share			
Income from continuing operations – U.S. GAAP	**$2.42**	$ 5.51	$ 4.38
Net income – U.S. GAAP	**$2.42**	$ 5.30	$ 4.35

(iv) Earnings per share (excluding special charges)

Earnings per share excluding special charges as disclosed in Note 20 would not be presented under U.S. GAAP.

C. Reconciliation of significant balance sheet items

(i) Employee share purchase loans

Amounts receivable under employee share purchase loans are included in Other current assets and Other assets and deferred charges for Canadian GAAP purposes. For U.S. GAAP purposes, these amounts would be classified as a reduction of Shareholders' equity.

(ii) Joint ventures

Interests in joint ventures are recognized using the proportionate consolidation method for Canadian GAAP. Under U.S. GAAP, joint ventures are accounted for using the equity method.

(iii) Shareholders' equity

As permitted under Canadian GAAP, the Company eliminated its accumulated deficit of $811 million as of June 30, 1995 through a reduction of the capital stock in the amount of $1,300 million, and created a contributed surplus of $489 million. Such a reorganization within Shareholders' equity is not permitted under U.S. GAAP.

Under Canadian GAAP, the dividend in kind declared in 1995 (with respect to land transfers) and other capital transactions were deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Retained earnings.

Under Canadian GAAP, costs related to the sale of shares have been deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Capital stock.

For Canadian and U.S. GAAP purposes, the Company designated all of its U.S. dollar denominated long-term debt as a foreign exchange hedge of its net investment in IC. Under Canadian GAAP, the resulting net unrealized foreign exchange gain, from the date of designation, has been included in Currency translation. For U.S. GAAP purposes, the resulting net unrealized foreign exchange gain as well as a minimum pension liability adjustment would have been included as part of Other comprehensive income in the Consolidated Statement of Comprehensive Income and Accumulated other comprehensive income, a separate component of Shareholders' equity, as required under FAS 130, "Reporting Comprehensive Income."

(iv) The application of U.S. GAAP would have a significant effect on the following balance sheet items as reported:

In millions *December 31,*	**1998**	1997
Current assets – Canadian GAAP	**$1,050**	$1,549
Joint ventures	**(7)**	(15)
Employee share purchase loans receivable	**(3)**	(1)
Deferred income taxes	**(2)**	–
Current assets – U.S. GAAP	**$1,038**	$1,533
Properties – Canadian GAAP	**$5,442**	$5,122
Property capitalization, net of special charges and depreciation	**1,380**	1,199
Joint ventures	**(34)**	(36)
Other	**15**	18
Properties – U.S. GAAP	**$6,803**	$6,303
Deferred income tax asset – Canadian GAAP	**$ 280**	$ 164
Property capitalization – cumulative effect of change in accounting policy	**(471)**	(471)
Cumulative effect of prior years' adjustment to income	**(40)**	–
Income taxes on current year U.S. GAAP adjustments	**(68)**	(40)
Deferred pension asset – cumulative effect of change in accounting policy	**(30)**	–
Other	**2**	–
Deferred income tax liability – U.S. GAAP	**$ (327)**	$ (347)
Investment in Illinois Central Corporation – Canadian GAAP	**$3,802**	$ –
Property capitalization	**19**	–
Investment in Illinois Central Corporation – U.S. GAAP	**$3,821**	$ –
Other assets and deferred charges – Canadian GAAP	**$ 290**	$ 240
Unrealized exchange loss on long-term debt	**(82)**	(68)
Joint ventures	**(4)**	(4)
Deferred pension asset, including cumulative effect of change in accounting policy	**86**	–
Employee share purchase loans receivable	**–**	(5)
Other assets and deferred charges – U.S. GAAP	**$ 290**	$ 163

In millions *December 31,*	1998	1997
Current liabilities – Canadian GAAP	$1,392	$1,205
Joint ventures and other	(12)	(27)
Current liabilities – U.S. GAAP	$1,380	$1,178
Other liabilities and deferred credits – Canadian GAAP	$1,172	$ 813
Stock-based compensation	40	29
Joint ventures and other	(7)	(6)
Other liabilities and deferred credits – U.S. GAAP	$1,205	$ 836
Long-term debt – Canadian GAAP	$4,009	$1,640
Joint ventures and other	(14)	(12)
Long-term debt – U.S. GAAP	$3,995	$1,628
Capital stock – Canadian GAAP	$2,873	$2,016
Capital reorganization	~~1,300~~	1,300
Employee share purchase loans receivable	(3)	(6)
Costs related to the sale of shares	~~(33)~~	(33)
Stock-based compensation	4	2
Capital stock – U.S. GAAP	$4,141	$3,279
Contributed surplus – Canadian GAAP	$ 190	$ 190
Capital reorganization	~~(489)~~	(489)
Dividend in kind with respect to land transfers	~~248~~	248
Costs related to the sale of shares	~~33~~	33
Other transactions and related income tax effect	~~18~~	18
Contributed surplus – U.S. GAAP	$ –	$ –
Currency translation – Canadian GAAP	$ 7	$ –
Minimum pension liability adjustment	(1)	–
Accumulated other comprehensive income – U.S. GAAP	$ 6	$ –
Retained earnings – Canadian GAAP	$1,221	$1,211
Capital reorganization	~~(811)~~	(811)
Dividend in kind with respect to land transfers	~~(248)~~	(248)
Other transactions and related income tax effect	~~(18)~~	(18)
Current year adjustments to net income	157	637
Cumulative effect of prior years' adjustments to income	597	(40)
Retained earnings – U.S. GAAP	$ 898	$ 731

D. Post-retirement benefits other than pensions

The disclosures required by FAS 132, "Employers' Disclosures about Pensions and Other Post-retirement Benefits," are as follows:

(i) Change in benefit obligation

In millions *Year ended December 31,*	1998	1997
Benefit obligation at beginning of year	$132	$126
Service cost	4	3
Interest cost	11	7
Foreign currency changes	2	–
Actuarial loss	30	3
Benefits paid	(7)	(7)
Benefit obligation at end of year	$172	$132

(ii) Funded status

In millions *December 31,*	1998	1997
Unfunded benefit obligation at end of year	$172	$132
Unrecognized net actuarial (loss) gain	(22)	9
Unrecognized prior service cost	(5)	(6)
Accrued benefit cost for post-retirement benefits other than pensions	$145	$135

(iii) Components of net periodic benefit cost

In millions *Year ended December 31,*	1998	1997	1996
Service cost	$ 4	$ 3	$ 3
Interest cost	11	7	6
Amortization of prior service cost	1	1	1
Recognized net actuarial loss (gain)	1	(2)	(8)
Net periodic benefit cost	$ 17	$ 9	$ 2

(iv) Weighted-average assumptions

December 31,	1998	1997	1996
Discount rate	6.00%	7.44%	8.00%
Rate of compensation increase	4.25%	4.50%	5.25%

The effect of a one-percentage-point increase or decrease in the assumed health care cost trend would be to increase or decrease the 1998 post-retirement benefit obligation by approximately $4 million.

Canadian GAAP

23 Reconciliation of Canadian and United States generally accepted accounting principles *(continued)*

E. Pension costs and obligation

The disclosures required by FAS 132 are as follows:

(i) Change in benefit obligation

In millions *Year ended December 31,*	1998	1997
Benefit obligation at beginning of year	$ 9,151	$8,428
Amendments	212	–
Service cost	81	51
Interest cost	629	614
Plan participants' contributions	76	77
Foreign currency changes	7	2
Effect of curtailment	23	–
Actuarial loss	1,006	593
Benefit payments and transfers	(645)	(614)
Benefit obligation at end of year	$10,540	$9,151

(ii) Change in plan assets

In millions *Year ended December 31,*	1998	1997
Fair value of plan assets at beginning of year	$ 9,984	$9,279
Actual return on plan assets	1,229	1,172
Employer contributions	77	68
Plan participants' contributions	76	77
Foreign currency changes	7	2
Benefit payments and transfers	(645)	(614)
Fair value of plan assets at end of year	$10,728	$9,984

(iii) Funded status

In millions *December 31,*	1998	1997
Excess of fair value of plan assets over benefit obligation at end of year	$ 188	$ 833
Unrecognized net actuarial gain	(372)	(929)
Unrecognized net transition obligation	96	122
Unrecognized prior service cost	193	9
Net amount recognized	$ 105	$ 35

(iv) Amount recognized in the Consolidated Balance Sheet

In millions *December 31,*	1998	1997
Prepaid benefit cost	$ 112	$ 42
Accrued benefit cost	(7)	(7)
Additional minimum liability	(5)	–
Intangible asset	3	–
Accumulated other comprehensive income	2	–
Net amount recognized	$ 105	$ 35

(v) Components of net periodic benefit cost

In millions *Year ended December 31,*	1998	1997	1996
Service cost	$ 81	$ 51	$ 45
Interest cost	629	613	611
Expected return on plan assets	(701)	(657)	(642)
Amortization of net transition obligation	21	20	20
Amortization of prior service cost	20	2	1
Recognized net actuarial loss	–	12	9
Net periodic benefit cost	$ 50	$ 41	$ 44

(vi) Weighted-average assumptions

December 31,	1998	1997	1996
Discount rate	6.00%	6.50%	7.50%
Rate of compensation increase	4.25%	4.50%	4.50%
Expected return on plan assets for year ending December 31	9.00%	8.25%	8.40%

As at December 31, 1998, one of the Company's pension plans had an accumulated benefit obligation ($114 million) in excess of the fair value of the plan assets ($102 million) which gives rise to additional minimum pension liability. The projected benefit obligation was $119 million at December 31, 1998.

Assuming the change in accounting policy for pension costs had been applied retroactively, the use of the corridor approach would have resulted in a net periodic cost of $29 million for 1997 and $36 million for 1996.

During 1998, the Company recorded a special charge for workforce reductions of $590 million which includes $36 million related to the curtailment of the Pension Plan. The curtailment increased the projected benefit obligation by $23 million and reduced the unrecognized transition obligation and unrecognized prior service cost by $5 million and $8 million, respectively.

24 Comparative figures

Certain figures, previously reported for 1997 and 1996, have been reclassified to conform with the basis of presentation adopted in the current year.

General review

Trustee

Montreal Trust Company of Canada (Montreal Trust) is the Trustee of the Canadian National Railways Pension Trust Funds (CN Pension Trust Funds, or Funds). As Trustee, Montreal Trust performs certain duties which include holding legal title to the assets of the Funds and ensuring that the Canadian National Railway Company (CN), as Administrator, complies with the provisions of the CN Pension Plan, the CN 1935 Pension Plan and the Pension Benefits Standards Act, 1985 and its regulations. The checks and direct deposit statements in respect of these plans are issued in the name of Montreal Trust, Trustee of the CN Pension Trust Funds.

Administration of the pension plans

Overall accountability for pension and benefit administration is the responsibility of CN. William M. Mercer Limitée, an employee benefits consulting firm, performs agreed-on pension and benefit administration services on behalf of CN.

Pension benefits

A. 1998 union negotiations

Some plan changes negotiated with the unions in 1998 were applied retroactively to January 1, 1998 and resulted in pension increases for many pensioners and survivors as well as improvements for active members.

The pension formula was changed for active members on January 1, 1998 from 1.3%/2.0% to 1.4%/2.0% and to 1.5%/2.0% for active members on January 1, 1999 for each year of pensionable service from January 1, 1966.

Survivor benefits increased to 55% from 50% and apply to death before and after retirement.

The waiting period for indexation benefits has been changed from age 63 and 5 years after retirement to age 60 and 5 years after retirement with indexation of 60% from 50% of inflation (maximum 6% inflation) if the Escalation Account exceeds 5% of the pensioners' actuarial liabilities. In addition, the maximum amount subject to indexation has been increased from $1,625 of monthly basic pension to $2,000 of monthly basic pension from January 1, 1998 and increases by $250 of monthly basic pension every year during the current and next contract.

A special adjustment of approximately $20 million has been allocated to adjust the pensions for pre-1990 retirees. The pension committee will decide on how the allocation will be made.

Other changes relating to the improvements in indexation and survivor benefits are discussed hereinafter.

B. Indexation agreement

As a result of the indexation agreement negotiated with the railroad unions in 1989 and improvements to such agreement negotiated in 1992 and 1998, approximately 42,400 retirees and surviving spouses received permanent pension increases in 1998. These increases amounted to 1.08% on the first $2,000 of the basic CN monthly pension, with a guaranteed minimum monthly pension increase of $9.00 for eligible retirees and $4.50 for eligible surviving spouses.

Under this indexation agreement, effective January 1, 1989, 50% of the experience gains or losses related to pensioners are accounted for separately in the Escalation Account. These net experience gains are used exclusively to pay for indexation of pensions above the minimum up to the maximum annual amount. The maximum annual indexation for eligible retirees and survivors is 60% of the increase in the Consumer Price Index (CPI) to a maximum increase in CPI of 6%, with an annual limit on the amount of pension which can be indexed. In 1998, the basic eligibility requirements to qualify for indexation were to have been retired for five complete calendar years and to have reached age 60.

Improvement accounts

Effective January 1, 1998, the unions and the Company agreed to share the experience gains (losses) resulting from investment earnings related to active unionized members of the CN Pension Plan based on the same concept as the indexation agreement. Annual calculations will determine the amounts to be credited (debited) to an account referred to as an Improvement Account, and the balance of such account, if positive, may be used to improve the benefits of unionized active members or reduce their contributions, as recommended by the pension committee. The Improvement Account concept has also been extended to non-unionized members. Separate accounts have been created for unionized and non-unionized members.

As part of the agreement, CN has allocated starting balances of $45 million and $12 million to the unionized and non-unionized Improvement Accounts, respectively.

The cost of the increased benefit formula to active members as of January 1, 1999 from the 1.4%/2.0% to 1.5%/2.0%, applicable to service prior to January 1, 2000, is to be charged to the Improvement Accounts as of December 31, 1998.

Annual pension statements

As required by the Pension Benefits Standards Act, 1985 and to keep employees who are members updated annually on their personal entitlement, personalized pension statements were prepared as at December 31, 1997 and distributed by June 1998.

Services to pensioners

A. Direct deposit:

The Direct Deposit System (DDS) is available to all retirees and survivors. Under this system, the monthly pension benefit is deposited directly into the individual's personal account. An itemized pension pay stub is sent to that individual initially, each January and whenever the gross or net amount changes. About 42,000 pensioners used this service in 1998.

B. Toll-free help lines:

Approximately 54,400 calls were handled in 1998 through the central toll-free help line (1-800-361-0739). Staff handling the toll-free telephone line have ready access to records and information required for quick, efficient and accurate responses to most callers' needs, in both of Canada's official languages.

Trustee's report

To the Administrator and the Members of the CN 1935 Pension Plan and the CN Pension Plan

We, Montreal Trust Company of Canada, are the Trustee of the Canadian National Railways Pension Trust Funds ("CN Pension Trust Funds").

As Trustee, we have appointed KPMG LLP to examine the systems, procedures and internal controls used in respect to the custody, investment, and administration of the assets of the CN Pension Trust Funds, the administration of the CN 1935 Pension Plan ("1935 Plan") and the CN Pension Plan, and the performance of Canadian National Railway Company ("CN") as Administrator of the 1935 Plan and the CN Pension Plan for the year ended December 31, 1998.

Our examination included such tests and procedures as were considered necessary in the circumstances taking into consideration the requirements of the Trust Deeds and our experience in the Canadian pension industry.

In our opinion, based on the reasonable, but not absolute, degree of assurance obtained from the examination performed, the aforementioned systems, procedures and internal controls, used by CN as Administrator, operated effectively during the year ended December 31, 1998, and complied with the objectives of the Pension Benefits Standards Act, 1985 and its Regulations.

Montreal Trust Company of Canada
Trustee of the Canadian National Railways
Pension Trust Funds

Montreal, January 19, 1999

Actuary's report

To the Board of Directors
Canadian National Railways Pension Trust Funds

We have conducted actuarial valuations for funding purposes as at December 31, 1997 for the CN Pension Plan and the CN 1935 Pension Plan.

As at December 31, 1997, these valuations revealed a consolidated actuarial liability of $8,743 million, a consolidated unfunded actuarial liability of $164 million and required consolidated Company contributions representing $76 million in 1998. The next actuarial valuations will be conducted as at December 31, 2000, at the latest.

In my opinion, for the purposes of the valuations,

- the data on which these valuations were based were sufficient and reliable;
- the assumptions are, in aggregate, appropriate; and
- the methods employed in the valuations are appropriate.

We have also conducted actuarial valuations for accounting purposes as at December 31, 1997 for the CN Pension Plan and the CN 1935 Pension Plan.

These valuations were made in accordance with requirements of Section 3460 of the Handbook of the Canadian Institute of Chartered Accountants (CICA). They revealed a consolidated actuarial liability of $8,632 million.

The difference between the results of the actuarial valuations conducted for funding purposes and those conducted for accounting purposes is due to the CICA's requirement to use the projected benefit method prorated on service to value the actuarial liability.

Both valuations have been prepared and, my opinions given, in accordance with accepted actuarial practice.

Bernard Morency
Fellow of the Canadian Institute of Actuaries
William M. Mercer Limitée

Montreal, January 19, 1999

Auditors' report

To the Board of Directors
Canadian National Railway Company

We have audited the consolidated statement of net assets of the CN Pension Plan and the CN 1935 Pension Plan as at December 31, 1998 and the consolidated statement of changes in net assets for the year then ended. These financial statements are the responsibility of the Administrator. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Administrator, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the net assets of the CN Pension Plan and the CN 1935 Pension Plan as at December 31, 1998 and the changes in their net assets for the year then ended in accordance with generally accepted accounting principles.

KPMG LLP

KPMG LLP
Chartered Accountants

Montreal, Canada
January 19, 1999

In millions *As at December 31,*	**1998**	1997
Bonds	**$ 4,212**	$3,581
Mortgages	**209**	173
Real estate	**448**	465
Oil and gas	**204**	229
Equities	**5,459**	4,810
Cash and short-term investments	**61**	633
	10,593	9,891
Receivable from Canadian National Railway Company	**5**	5
Other assets (liabilities)	**18**	(22)
	$10,616	$9,874

On behalf of the Board:

David G.A. McLean
Director

Paul M. Tellier
Director

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS AT MARKET VALUE

In millions Year ended December 31,	1998	1997
Net assets at market value, beginning of year	$ 9,874	$9,184
Investment income		
Bonds	246	223
Mortgages	14	11
Real estate	9	12
Oil and gas	15	18
Equities	67	101
Short-term investments	13	24
	364	389
Less administrative expenses	(11)	(10)
Investment income before gains on sales of investments	353	379
Gains on sales of investments	407	527
Total investment income	760	906
Unrealized appreciation in value of investments	463	249
Contributions		
Employees	76	77
Company	77	63
Total contributions	153	140
Disbursements for members		
Pension benefits paid	(568)	(554)
Refunds	(58)	(47)
Total disbursements for members	(626)	(601)
Transfers	(8)	(4)
Net increase	742	690
Net assets at market value, end of year	$10,616	$9,874

See accompanying notes to consolidated financial statements.

1 Description of plans

These consolidated financial statements cover two pension plans, the CN Pension Plan and the CN 1935 Pension Plan (CN Plans), and include the accounts of the Canadian National Railways Pension Trust Funds and its wholly-owned companies. All references in these financial statements to the "Company" refer to Canadian National Railway Company, which is the Administrator of the CN Plans. The CN 1935 Pension Plan is for a closed group of members and represents less than 1% of the pension obligation of the plans. Therefore, the following is a summarized description of the CN Pension Plan only. Please refer to the rules of the CN Pension Plan for additional information.

A. General

The CN Pension Plan (Plan) is a contributory defined benefit pension plan generally applicable for new employees from the first day of employment. Under the Plan, employees contribute between 5.48% and 5.88% of earnings up to the Year's Maximum Pensionable Earnings (YMPE) under the Canada or Quebec Pension Plan and between 6.98% and 7.38% of earnings in excess of the YMPE up to a maximum of $6,204 in 1998. Participants are not required to make contributions after 35 years of pensionable service. Company contributions are determined on the basis of actuarial valuations done at least on a triennial basis in accordance with the requirements of the Pension Benefits Standards Act, 1985 and regulations thereunder.

B. Pensions

Pensions are based on the employee's average pensionable earnings for the best five consecutive calendar years or the last 60 months of employment at the rate of 2% for each year of pensionable service prior to January 1, 1966, 1.4% for each year of pensionable service thereafter up to the average YMPE over the last 60 months (1.5% for active employees as of January 1, 1999), and 2% of the excess of such average pensionable earnings over the average YMPE. The maximum annual pension payable is $1,715 multiplied by the pensionable service of the member. Pensionable service is limited to 35 years.

C. Retirement age

The normal retirement age is 65. However, employees with 85 points (age plus pensionable service) and the Company's consent are entitled to an early retirement pension without reduction as long as they are at least 55 years of age. Furthermore, employees with less than 85 points can retire anytime from age 55 with a reduction in their pension of 0.5% for each month (6% per year) between their date of retirement and their 65th birthday.

D. Disability pensions

A member with 10 years of pensionable service who is either declared unfit to perform his/her usual employment with the Company due to a permanent disability which occurred prior to 1992 or is declared totally and permanently disabled due to a disability which occurred after 1991 may apply for an immediate unreduced pension. Any declarations in respect of a member's disability are the responsibility of CN's Chief Medical Officer.

E. Pre-retirement survivors' pensions and death refunds

A survivor's pension is payable to the eligible spouse of a member who had a minimum of two years of plan membership upon his/her death. Otherwise, a death refund is payable to the spouse, or, if there is no spouse, to the estate of the member.

F. Post-retirement survivors' pensions and estate settlements

Upon the death of a retiree who had an eligible spouse at retirement, either 55% or 60% of the basic pension of the retiree is payable to that spouse during his/her lifetime depending on the option elected at retirement. The survivor pension is guaranteed for the first 10 years after retirement. If the retiree and the surviving spouse, if any, die in the first 10 years after retirement, the survivor pension will be payable to the estate of the retiree until the 10-year period is over.

G. Termination benefits

Upon termination of service, a member is entitled to either his/her contributions with interest or to the value of his/her benefits accrued under the Plan or to a deferred pension or a combination of the above, depending on his/her age, pensionable service and years of membership at termination.

H. Income taxes

The Plan is registered under the Income Tax Act and regulations. Contributions to the Plan are tax deductible and investment income of the Canadian National Railways Pension Trust Funds is not taxable in Canada. Investment income from some foreign countries is subject to withholding taxes which are either fully or partially recovered.

2 Summary of significant accounting policies

A. Basis of presentation

These consolidated financial statements are prepared on a market value basis in accordance with generally accepted accounting principles in Canada for pension plans, which requires management to make estimates and assumptions that affect the reported amounts at the date of the financial statements. Actual results could differ from these estimates. These statements present the aggregate financial position of the CN Plans as a separate financial reporting entity, independent of the sponsor and plan members, and are prepared to assist plan members and others in reviewing the activities of the CN Plans for the year, but they do not portray the funding requirements of the Plans or the benefit security of individual members.

Certain of the figures reported for 1997 have been reclassified to conform with the basis of presentation adopted for the current year.

B. Valuation of net assets

Market value is determined using publicly quoted prices where available. When such prices are not available, market values are estimated on the basis of: the present value of estimated future net cash flows, the market value of comparable assets, or the breakup value of underlying assets.

Valuation of net assets by category is as follows:

(i) Bonds are valued using the closing market bid as at December 31.

(ii) Mortgages are valued using current market yields of financial instruments of similar maturity and at appropriate spreads from instruments of comparable quality.

(iii) Real estate consists of land, buildings and equities. Land is valued using the market value of comparable assets, and buildings are valued using the present value of estimated future net cash flows and the market value of comparable assets. Independent valuations of land and buildings are performed triennially. Equities are valued using closing market quotations as at December 31.

(iv) Oil and gas reserves are valued using the present value of estimated future net cash flows, which are based on projected production, prices and costs. Land is valued using the market value of comparable assets. Trust units are valued using the closing market price as at December 31.

(v) Equities are valued using the closing market price as at December 31.

(vi) Short-term investments and other assets are valued at cost, which approximates market value.

(vii) Listed derivative financial instruments are valued using the market settlement price as at December 31. Unlisted derivative financial instruments are valued using the present value of future net cash flows determined by using closing market levels and interest rates for instruments of similar maturity and credit risk.

C. Income recognition

Dividends are accrued on the ex-dividend date; income from other investments is accrued as earned. Gains or losses on sales of investments are recognized on the dates of sales and are calculated on the basis of the average cost of the assets.

D. Foreign exchange

Investments denominated in foreign currencies are translated using current rates as at December 31 or at the forward foreign exchange contract rates for investments that are hedged. Foreign dividends and interest income are translated at the rates prevailing when accrued.

E. Change in market value

The change in market value has been segregated in the Consolidated Statement of Changes in Net Assets at Market Value between gains or losses on the sales of investments during the year and the unrealized appreciation (depreciation) in the value of investments, which is the balance of the change in market value of investments for the year.

F. Contributions

Contributions from employees are recorded in the period in which the Company makes payroll deductions. The contributions from the Company, as determined by the latest actuarial valuations, are recorded using the accrual method.

G. Transfers

Transfers to/from other funds are accounted for in the period in which the value of the transfers can be reasonably estimated.

3 Investments

All investments are securities, assets or financial instruments where the Plans' original intention is to hold to maturity or until market conditions render alternative investments more attractive. Significant terms and conditions of investments are as follows:

Bonds, 75% (80% in 1997) of which are issued or guaranteed by Canadian or U.S. governments, 16% (6% in 1997) by corporations and 9% (14% in 1997) by supranational agencies, have a market weighted-average coupon of 7.9% (7.9% in 1997). Maximum term is 31 years (29 years in 1997) with an average term of 12.9 years (10.7 years in 1997).

Mortgages, secured by real estate, have a market weighted-average coupon of 7.9% (9.0% in 1997). Maximum term is 24 years (14 years in 1997) with an average term of 9.0 years (7.6 years in 1997).

Equities are diversified by issuer, industry and country. Canadian domiciled companies represent 37% (57% in 1997) of the equity portfolio, and allocations to individual issuers or industry sectors are limited to 2.7% and 13.7% (3.5% and 10.2% in 1997), respectively.

Short-term investments, primarily securities issued by the Government of Canada and Canadian chartered banks, have an average term of five days (six days in 1997) and an average yield of 5.0% (4.5% in 1997).

Derivatives are financial instruments whose value is derived from interest rates, foreign exchange rates, equity or commodity prices. Derivatives include forwards, futures, swaps and options.

From time to time, the CN Plans use derivatives in connection with their asset/liability management to hedge foreign exchange, interest rate or market risks of the portfolio or anticipated transactions.

3 Investments *(continued)*

Notional amounts of derivative contracts by risk category affected were as follows:

In millions *As at December 31,*	1998	1997
Foreign currency	$1,189	$526
Interest rate	445	–

The weighted-average term of the above contracts was 47 days (one year in 1997). The value of derivative instruments is $9 million ($(3) million in 1997) and is included in the value of bonds, which is the asset class hedged.

4 Credit risk

Credit risk arises from the potential for an investee to fail or a counterparty to default on its contractual obligations to the Plans.

In accordance with formally established policies, the Plans manage credit risk by dealing with counterparties considered to be of high credit quality, utilizing an internal credit limit monitoring process as well as credit mitigation techniques such as master netting and collateral agreements.

At year-end, the Plans' most significant concentration of credit risk was with the Government of Canada, which issued or guaranteed $2,258 million ($2,493 million in 1997) of securities held by the Plans. Excluding the above, the remainder of assets are diversified with no other counterparty accounting for more than 2.4% (2.2% in 1997) of total net assets.

The credit risk of derivative instruments is limited to the cost of replacing, at current market value, all contracts which have a positive value. The following table shows the credit risk of all derivative instruments outstanding at year-end.

Credit risk – Derivative instruments

In millions *As at December 31,*	1998	1997
Maximum exposure	$ 10	$ 1
Less effect of master netting and collateral agreements	(1)	–
Net credit risk	$ 9	$ 1

5 Funding policy

In respect of the CN Plans, the contributions by the Company are determined in accordance with the requirements of the Pension Benefits Standards Act, 1985 and regulations thereunder, and are based on the projected unit credit actuarial cost method, with projection of salaries where future salary changes affect the amount of the projected benefits. Consistent with the regulations and in addition to the current service contribution, the Company is making quarterly special payments to liquidate the unfunded actuarial liability by 2012. Also, in the case of the CN 1935 Pension Plan, the Company makes money purchase contributions in accordance with the rules of the plan.

The latest actuarial valuations of the CN Plans were prepared by William M. Mercer Limitée as at December 31, 1997 and were submitted to the Superintendent of Financial Institutions and to Revenue Canada. In these actuarial valuations, the principal assumptions adopted by the Plans' actuary are: members' mortality, disability, retirement, termination of employment, merit and periodic increases in earnings, as well as a long-term rate of return of 7.5% per annum on investments. Future increases in members' earnings have been projected using economic assumptions consistent with this long-term rate of return.

6 Transfers

In 1998, the accounts included a provision for the amounts to be remitted to/from other funds to cover transfers of members of CN Plans to other pension plans and transfers of members of other plans to the CN Plans.

7 Consolidated actuarial pension obligation and asset value

The actuarial valuations as at December 31, 1997 revealed a consolidated actuarial liability of $8,632 million and a consolidated actuarial asset value of $8,578 million. The results of these valuations were then used to estimate the corresponding figures as at December 31, 1998, which approximate $8,870 million and $8,970 million, respectively, as at that date. The principal components of the change in the pension obligations are the interest accrued on benefits ($630 million in 1998 and $600 million in 1997), disbursements paid for members ($626 million in 1998 and $601 million in 1997) and benefits accrued during the year ($240 million in 1998 and $250 million in 1997). The consolidated actuarial asset value is based on a market-related method which recognizes the change in market value over a period of five years using the straight-line method.

8 Uncertainty due to Year 2000 issue

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the Year 2000 as 1900 or some other date, resulting in errors when information using Year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the CN Plans' ability to conduct normal business operations. There can be no assurance that all aspects of the Year 2000 issue affecting the CN Plans, including those related to the efforts of the plan members or other third parties, will be fully resolved.

David G. A. McLean, LL.D.
Chairman of the Board
Canadian National
Railway Company
Chairman and
Chief Executive Officer
The McLean Group
Vancouver, BC
Committees: 2*, 3, 5, 6, 7

Michael R. Armellino
Limited Partner
The Goldman Sachs Group
New York, NY
Committees: 1, 6, 7

Purdy Crawford, O.C., Q.C., LL.D.
Chairman
Imasco Limited
Toronto, ON
Committees: 2, 5*, 6, 7

J. V. Raymond Cyr, O.C., LL.D.
Chairman
Geomat International Inc.
and Poly Valor Inc.
Montreal, QC
Committees: 1, 4*, 7

James K. Gray, O.C., LL.D.
Chairman
Canadian Hunter
Exploration Ltd.
Calgary, AB
Committees: 4, 5

V. Maureen Kempston Darkes, D.Comm., LL.D.
President and
General Manager
General Motors of Canada
Limited
Toronto, ON
Committees: 1, 4

The Honorable
Richard H. Kroft, C.M.
Member of the Senate
of Canada
Winnipeg, MB
Committees: 1, 5, 6*

Gilbert H. Lamphere
Private Investor and
Former Chairman
of the Board
Illinois Central Corporation
New York, NY
Committees: 2, 7


David G. A. McLean | V. Maureen Kempston Darkes | Alexander P. Lynch
Michael R. Armellino | The Hon. Richard H. Kroft | Dr. Edward P. Neufeld
Purdy Crawford | Gilbert H. Lamphere | Robert Pace
J. V. Raymond Cyr | Denis Losier | Cedric E. Ritchie
James K. Gray | The Hon. Edward C. Lumley | Paul M. Tellier

Denis Losier
President and
Chief Executive Officer
Assumption Life
Moncton, NB
Committees: 2, 6

The Honorable
Edward C. Lumley, P.C., LL.D.
Vice-Chairman
Nesbitt Burns Inc.
Toronto, ON
Committees: 2, 7

Alexander P. Lynch
General Partner
The Beacon Group
New York, NY
Committees: 1, 5

Dr. Edward P. Neufeld
Economist
Mississauga, ON
Committees: 4, 7

Robert Pace
President and Chief
Executive Officer
The Pace Group
Halifax, NS
Committees: 1*, 4, 5

Cedric E. Ritchie, O.C., LL.D.
Corporate Director and
Former Chairman and
Chief Executive Officer
The Bank of Nova Scotia
Toronto, ON
Committees: 1, 2, 6, 7*

Paul M. Tellier,
P.C., C.C., Q.C., LL.D.
President and
Chief Executive Officer
Canadian National
Railway Company
Montreal, QC
Committees: 3*, 7

Committees:

1 Audit and finance
2 Corporate governance
3 Donations
4 Environment and safety
5 Human resources
6 Investment
7 Strategic planning

* denotes chairman of the committee

David G. A. McLean
Chairman

Paul M. Tellier
President and Chief Executive Officer

Robert F. Dolan
Senior Vice-President
Corporate Services

James M. Foote
Senior Vice-President
Marketing

E. Hunter Harrison
Executive Vice-President and
Chief Operating Officer

Keith L. Heller
Senior Vice-President
Line Operations

Jack T. McBain
Executive Vice-President
Operations

Jean Pierre Ouellet
Chief Legal Officer and
Corporate Secretary

Michael J. Sabia
Executive Vice-President and
Chief Financial Officer

Torrance Wylie
Senior Vice-President
Public Affairs

Tullio Cedraschi
President and
Chief Executive Officer
CN Investment Division

Sean Finn
Treasurer and
Principal Tax Counsel

Fred R. Grigsby
Vice-President and
Chief Information Officer

Wes T. Kelley
Vice-President
Public Affairs and Advertising

S. Craig Littzen
Vice-President
Intermodal and Automotive

Peter C. Marshall
Vice-President
Bulk Commodities

J. Paul Mathieson
Vice-President
Network Operations

Sandi J. Mielitz
Vice-President
Market Planning

Claude Mongeau
Vice-President
Strategic and
Financial Planning

Janice Murray
Chief
Internal Audit

Robert E. Noorigian
Vice-President
Investor Relations

Serge Pharand
Vice-President and
Corporate Comptroller

Rick W. Richardson
Vice-President
Engineering

Tony A. Rossi
Vice-President
Transportation

David E. Todd
Vice-President
Government Affairs

Frank J. Trotter
President and
Chief Executive Officer
Canac Inc. and
C.T. Management Inc.

Dennis E. Waller
Vice-President
Mechanical

SHAREHOLDER AND INVESTOR INFORMATION

Annual meeting
The annual meeting of shareholders will be held from 10:30 a.m. to 11:45 a.m. on Tuesday, April 27, 1999, at The Westin Harbour Castle, Toronto, Ontario.

Annual information form
The annual information form may be obtained by writing to:

The Corporate Secretary
Canadian National Railway Company
935 de La Gauchetière Street West
Montreal, Quebec H3B 2M9

Transfer agent and registrar
Montreal Trust Company of Canada

Offices in:
Halifax, NS; Montreal, QC; Toronto, ON; Winnipeg, MB; Calgary, AB; Edmonton, AB; Vancouver, BC

Co-transfer agent and co-registrar
The Bank of Nova Scotia Trust Company of New York
165 Broadway
1 Liberty Plaza
New York, NY 10006

U.S. cash dividend plan
Shareholders wishing to receive dividends in U.S. dollars may obtain detailed information by communicating with:

Montreal Trust Company of Canada
Telephone: (514) 982-7555 or 1-800-527-2221

Stock exchanges
Canadian National common shares are listed on the Toronto, New York and Montreal stock exchanges.

Ticker symbols:
CNR (Toronto stock exchange)
CNI (New York stock exchange)
CNR (Montreal stock exchange)

Investor relations
Robert Noorigian
Vice-President, Investor Relations
Telephone: (514) 399-0052

Shareholder services
Shareholders having inquiries concerning their shares or wishing to obtain information about CN should contact:

Montreal Trust Company of Canada
Shareholder Services
1800 McGill College Avenue
Place Montréal Trust, 6th Floor
Montreal, Quebec H3A 3K9
Telephone: (514) 982-7555 or 1-800-527-2221

Head office
Canadian National Railway Company
935 de La Gauchetière Street West
Montreal, Quebec H3B 2M9

P.O. Box 8100
Montreal, Quebec H3C 3N4

Additional copies of this report are available from:

Canadian National
Public Affairs and Advertising
935 de La Gauchetière Street West
Montreal, Quebec H3B 2M9
Telephone: (514) 399-7212
Toll free: 1-888-888-5909
Fax: (514) 399-5344
www.cn.ca

La version française du présent rapport est disponible à l'adresse suivante :

Canadien National
Affaires publiques et publicité
935, rue de La Gauchetière ouest
Montréal (Québec) H3B 2M9
Téléphone : (514) 399-7212
Numéro sans frais : 1-888-888-5909
Télécopieur : (514) 399-5344
www.cn.ca

This report has been printed on recycled paper.

Partners in Responsible Care®

Canadian National 935 de La Gauchetière Street West, Montreal, Quebec H3B 2M9 www.cn.ca